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The Corporate Governance Gap

ABSTRACT. A reliable system of corporate governance is considered an important requirement for the long-term success of public companies and for the good of society at large. After decades of research and policy advocacy, there is a growing sense that corporations are finally nearing the promised land: boards of public corporations seem more diverse, large investors seem more engaged, and directors seem more accountable than ever. But is this perception accurate? While many large, high-profile companies tend to serve as role models of desirable governance practices, the picture of corporate governance—as this Article reveals—is considerably different in the far corners of corporate America, away from the limelight of the Fortune 500 and within the universe of small-cap corporations. In these smaller, less-scrutinized corporations, the adoption of governance arrangements is less systematic and often significantly departs from the norms set by larger companies. This results in what this Article calls the "Corporate Governance Gap."

What prompts this governance gap? Corporate governance, we argue, is not self-driven. It requires engagement with agents and forces of change, which, as we detail theoretically and empirically, are less likely to be as prevalent or effective for smaller corporations. Corporate governance scholars have long debated the merits of contractual freedom in corporate law. This debate cannot be resolved without a fuller understanding of how governance terms are disseminated in the marketplace and without a recognition of the Corporate Governance Gap between large and small companies.

This Article, the first to address the sharp divide in the governance of American corporations, makes three key contributions. First, using a comprehensive, hand-collected dataset, it offers an empirical account of the differences in governance practices, shedding new light on the corporate governance of small-cap firms. Second, the Article develops a theoretical account of the forces that promote corporate governance changes, which help explain the stark governance gap. Finally, the Article proposes policy reforms aimed at overcoming the gap between large and small firms' corporate governance norms, with the potential of prompting a new line of inquiry regarding the role of key governance agents in smaller public companies.

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INTRODUCTION

Corporate America is omnipresent. From their financial impact on our retirement accounts and communities, to their environmental and social policies, corporations can act as drivers of change or as bricks of resistance. But corporate America is not an abstract concept. It is the aggregate of thousands of corporations, each operating independently and guided by its own set of governance policies. From climate change to gender equality, corporations—and the corporate governance policies that drive them—wield the power to transform society.[1]

Corporate governance discourse has long realized the important social role of corporations and the significance of governance to fulfilling that role. Dating back to Adolf A. Berle and Gardiner C. Means's renowned examination of the modern corporation,[2] the exploration of how and why corporations operate in the ways they do has dominated academic debate[3] and regulatory policy,[4] ushering the field of empirical corporate governance.[5]

After decades of research and policy advocacy, there is a growing sense that corporations are finally nearing the promised land. Boards of public corporations seem more diverse, large investors more engaged, and directors more accountable than ever. But is this perception really true? While many large, high-profile

1. *See, e.g.*, Yaron Nili & Cathy Hwang, *Shadow Governance*, 108 CALIF. L. REV. 1097, 1141 (2020) (empirically detailing the importance of governance policies for the workings of corporations).

2. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

3. *See generally* Robert Bartlett & Eric Talley, *Law and Corporate Governance*, *in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177, 178 (2017) (discussing the "key legal institutions that help shape corporate governance practices"); Ronald J. Gilson, *From Corporate Law to Corporate Governance* 6 (Eur. Corp. Governance Inst., Law Working Paper No. 324, 2016) (describing how the study of corporate decision-making and performance progressed "from legal rules standing alone to legal rules interacting with non-legal processes and institutions"); Mariana Pargendler, *The Corporate Governance Obsession*, 42 J. CORP. L. 359, 361-68 (2016) (discussing the growth in interest in corporate governance over time).

4. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406, 116 Stat. 745, 789 (codified as amended at 15 U.S.C. § 7264 (2018)); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C. (2018)); Good Faith Determinations of Fair Value, 86 Fed. Reg. 748, 795 (Jan. 6, 2021) (to be codified at 17 C.F.R. pts. 210, 270); Amendments to Financial Disclosures About Acquired and Disposed Businesses, 85 Fed. Reg. 54002, 54043 n.442 (Aug. 31, 2020) (codified at 17 C.F.R. pts. 210, 230, 239-40, 249, 270, 274).

5. *See, e.g.*, Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 144-45 (2003); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113, 1151-52 (1998).

companies tend to serve as role models of "good" governance practices, the picture, as this Article reveals, is much different in the far corners of corporate America.

Stepping away from the limelight of the Standard & Poor's 500 (S&P 500) corporations[6] and into the universe of small-cap corporations, governance standards differ significantly. In these smaller, less scrutinized corporations, the adoption of governance arrangements is less organized and systematic, often representing a significant departure from the norms set by larger companies. We call this the "Corporate Governance Gap." Beyond Apple, Google, and General Electric, there is a whole universe of publicly traded companies—3,530 to be exact[7]—many of which have corporate governance regimes that have little in common with the polished ones seen in the staple corporations of our society.

Consider the case of gender diversity on corporate boards. Today's general consensus among scholars and news outlets is that boards are steadily inching towards gender parity.[8] The S&P 500 was lauded in 2019 when the last remaining all-male board finally added a woman member.[9] But this narrative ignores the reality in many small-cap companies that are approximately ten years behind large-cap companies in terms of board gender diversity. As of 2021, 25% of the

6. This Article gathers data from companies listed in Standard & Poor's 1500 (S&P 1500). The indexes are weighted by float-adjusted market capitalization and require unadjusted company market capitalization of $9.8 billion or more for the Standard & Poor's 500 (S&P 500), $3.2 billion to $9.8 billion for the S&P Mid-Cap 400 (S&P 400), and $700 million to $3.2 billion for the S&P Small-Cap 600 (S&P 600). *See S&P Composite 1500*, S&P GLOB. (Oct. 29, 2021), https://www.spglobal.com/spdji/en/idsenhancedfactsheet/file.pdf?calcFrequency=M&force_download=true&hostIdentifier=48190c8c-42c4-46af-8d1a-0cd5db894797&indexId=1636 [https://perma.cc/7UZF-UBVY]. We also collected information for the bottom 200 companies of the Russell 3000 for each year based on a ranking determined by the FactSet database.

7. Matt Krantz, *Chasing Right Stocks to Buy Is Critical with Fewer Choices but Big Winners*, INV.'S BUS. DAILY (Nov. 27, 2020, 1:15 PM ET), https://www.investors.com/news/publicly-traded-companies-fewer-winners-huge-despite-stock-market-trend [https://perma.cc/546X-WYP2].

8. *See* Lily Jamali, *A Push to Get More Women on Corporate Boards Gains Momentum*, NPR (Mar. 5, 2020, 12:55 PM ET), https://www.npr.org/2020/03/05/811192459/a-push-to-get-more-women-on-corporate-boards-gains-momentum [https://perma.cc/4P9B-PP39]; Michael Peregrine, *California Ushers in a Bold New Era of Board Diversity*, FORBES (Oct. 2, 2020, 6:00 AM EDT), https://www.forbes.com/sites/michaelperegrine/2020/10/02/california-ushers-in-a-bold-new-era-of-board-diversity [https://perma.cc/482S-PWE8]. *But see* Catherine H. Tinsley, James B. Wade, Brian G.M. Main & Charles A. O'Reilly, *Gender Diversity on U.S. Corporate Boards: Are We Running in Place?*, 70 INDUS. LAB. RELS. REV. 160, 160 (2017) (explaining that despite increased attention to women on corporate boards, little evidence supports significant progress on this front in the past decade).

9. Maggie Fitzgerald, *There Is Now a Woman Board Member at Every S&P 500 Company*, CNBC (July 25, 2019, 2:35 PM EDT), https://www.cnbc.com/2019/07/25/there-is-now-a-woman-board-member-at-every-sp-500-company.html [https://perma.cc/QJQ2-KK65].

companies with less than $500 million in assets had no female directors on their boards.[10] Additionally, when California enacted Senate Bill 826 in 2018, which required publicly traded companies' boards to add at least one woman to their ranks,[11] the preponderance of noncompliant companies were small companies.[12] Despite this striking noncompliance, most of the discussion surrounding this new law focused on its success in bringing women onto the boards of the largest corporations in the state.[13]

Diversity on boards is just one of many examples of the sharp divide between America's largest corporations and small-cap corporations. As this Article reveals in its novel empirical examinations, stark governance disparities between large and small corporations prevail across a myriad of governance metrics. Compiling historical data over the last twenty years, we compare governance provisions of S&P 500 companies with those of small public companies and find a 30% gap in the implementation of annual director elections, a 60% gap in the implementation of majority voting for director elections, a 20% gap in the elimination of a supermajority requirement for amending the company charter, and a 70% gap in the implementation of proxy access.[14] We also find that investors tend to focus on large companies, with 70% of all shareholder proposals and 80% of all exempt activist campaigns targeted at the S&P 500 companies.[15] Similarly, the "Big Three" indexing giants of Wall Street (BlackRock, State Street Global Advisors, and Vanguard) heavily focus their engagement efforts on large companies.[16]

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10. Matteo Tonello, *Corporate Board Practices in the Russell 3000, S&P 500, and Midcap 400: 2021 Edition*, CONF. BD. 15 (2021), https://conference-board.org/pdfdownload.cfm?masterProductID=36996 [https://perma.cc/8NU3-Y6Z8]. For more context on the Russell 3000 Index, see Adam Hayes, *Russell 3000 Index*, INVESTOPEDIA (June 28, 2021), https://www.investopedia.com/terms/r/russell_3000.asp [https://perma.cc/H9W5-V43Q], which describes the Russell 3000 Index as "a market-capitalization-weighted equity index maintained by FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks, which represent about 98% of all U.S.-incorporated equity securities."

11. Act of Sept. 30, 2018, ch. 954, 2018 Cal. Stat. 6263, 6265-66 (codified at CAL. CORP. CODE §§ 301.3, 2115.5 (West 2021)) (requiring publicly held corporations to have at least one female member on their boards of directors).

12. Jessica Guynn, *#MeToo for the Boardroom: California Gender Diversity Law Could Lead to More Women Quotas Nationally*, USA TODAY (July 9, 2020, 6:28 PM ET), https://www.usatoday.com/story/money/2019/12/30/california-gender-diversity-law-could-lead-more-women-quotas/2753270001 [https://perma.cc/HCK8-UM53].

13. *See, e.g.*, *Clock Is Ticking for All-Male Boards at California Public Companies*, TIMES SAN DIEGO (Dec. 21, 2019), https://timesofsandiego.com/business/2019/12/21/clock-is-ticking-for-all-male-boards-at-california-public-companies [https://perma.cc/XC9V-6CD5].

14. *See infra* Section II.A.

15. *See infra* Section II.B.

16. *See infra* Section II.C.

These profound differences matter because the 3,000 companies that are not in the S&P 500 still account for about 30% of the U.S. capital markets—a collective value of $10 trillion.[17] The limited attention that these firms receive from investors, as well as other important market participants, suggests that they often operate free from any meaningful disciplinary forces. This is despite the fact that their governance practices and lack of managerial oversight could have a negative impact on their investors, stakeholders, employees, and society at large. A small oil-drilling company can still create massive environmental harm, and a small manufacturing company can still pollute a nearby river with carcinogens affecting nearby cities. While the harm caused by any single megafirm may be larger than one generated by a comparable mid-sized or small firm, there are significantly more small firms in the marketplace and their cumulative impact on their investors and other stakeholders is substantial.

Properly addressing the Corporate Governance Gap involves more than merely recognizing departures from investors' desired norms set by larger companies. It also requires a careful review of the factors that create and preserve the Gap. Corporate governance, we argue, is not self-driven. It requires engagement with agents and forces of change, which, as we detail theoretically and empirically, are less likely to be as prevalent or effective within smaller corporations.

The sharp divide in governance practices cannot be explained away by hypothesizing that smaller organizations require drastically different governance arrangements—although that may be the case in some instances.[18] Despite a clear consensus among investors regarding the desirability of governance structures across *all* firms, smaller companies do not react as uniformly or as quickly compared to large firms. This raises not only the questions of how governance policies change and what drives that change, but also how a distorted view of governance may affect public perception, investment choices, and regulatory intervention.

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17. To retrieve the market cap of all public companies outside the S&P 500, we first calculated the total market cap of public companies in the U.S., and then subtracted from it the market cap of the companies included in the S&P 500.

18. For prominent scholars supporting this view, see *infra* note 84.

Indeed, despite the alternative governance universe of smaller companies, much of the current discourse in both practice[19] and academia[20] treats corporate governance in the aggregate, often focusing on the most observable of companies—the large Fortune 500 corporations—that sway opinions and give rise to generalizations. The attention frequently directed at these large corporations is often pivotal in shaping policies and perceptions of corporate governance.[21] However, the human tendency to assume that trends observed in large corporations exist across the board is as problematic as estimating an iceberg's size based on the size of its tip.

The focus on larger companies is particularly concerning considering the increasing use of trading platforms by retail investors. Over the last half century, institutional investors had overtaken retail investors[22] in the U.S. securities markets.[23] However, the introduction of mobile-trading apps, such as Robinhood Markets, Inc. (Robinhood), disrupted the retail-brokerage industry by offering

19. *See, e.g.*, Ning Chiu, *Benchmarking Against the Spencer Stuart S&P 500 Board Practices Report*, DAVIS POLK (Nov. 6, 2018), https://www.davispolk.com/insights/client-update/benchmarking-against-spencer-stuart-sp-500-board-practices-report [https://perma.cc/Z9HF-TZGW]; Mateo Tonello, *Corporate Board Practice in the S&P 500 and Russell 3000: 2019 Edition*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 7, 2019), https://corpgov.law.harvard.edu/2019/05/07/corporate-board-practices-in-the-sp-500-and-russell-3000-2019-edition [https://perma.cc/Z5ZW-FDTS]; Holly J. Gregory, Rebecca Grapsas & Claire Holland, *The Latest on Proxy Access*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 1, 2019), https://corpgov.law.harvard.edu/2019/02/01/the-latest-on-proxy-access [https://perma.cc/9QTJ-7PWR].

20. *See* Melinda S. Molina, *Addressing the Lack of Diversity on Corporate Boards: Building Responsive Law School Pedagogy and Curriculum*, 49 LOY. U. CHI. L.J., 669, 670-72 (2018); Aubrey Bout, Brian Wilby & Perla Cruz, *S&P 500 CEO Compensation Increase Trends*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2020), https://corpgov.law.harvard.edu/2020/02/11/sp-500-ceo-compensation-increase-trends-3 [https://perma.cc/4ZCA-WSL5].

21. *See* Courtney Connley, *For the First Time in over 20 Years, All S&P 500 Boards Have at Least One Woman*, CNBC (Dec. 16, 2020, 11:18 AM EST), https://www.cnbc.com/2020/12/15/all-sp-500-boards-have-at-least-1-woman-first-time-in-over-20-years.html [https://perma.cc/8VQS-P5L2]; Xin Li & Tih Koon Tan, *Governance Changes for Firms Added to the S&P 500*, 9 INT'L J. BUS. & FIN. RSCH. 21, 22 (2015); Robert J. Jackson Jr., *Corporate Governance: On the Front Lines of America's Cyber War*, U.S. SEC. & EXCHANGE COMM'N 3-10 (Mar. 15, 2018), https://www.sec.gov/news/speech/speech-jackson-cybersecurity-2018-03-15 [https://perma.cc/V7SD-NTLB].

22. A retail investor is an individual who owns stock either directly or indirectly; the term differentiates individual investors from institutional investors. Jennifer O'Hare, *Retail Investor Remedies Under Rule 10b-5*, 76 U. CIN. L. REV. 521, 523 (2008).

23. *Id.* at 523 n.6 ("By 2004, less than a third of U.S. stocks were directly owned by individual investors."); John C. Bogle, *Individual Stockholder, R.I.P.*, WALL ST. J. (Oct. 3, 2005, 12:01 AM ET), https://www.wsj.com/articles/SB112829417598858002 [https://perma.cc/4H47-L4UP].

free trading via a user-friendly mobile app.[24] Robinhood attracted millions of investors, mostly millennials,[25] thereby increasing retail investing.[26] Robinhood's "gamified" interface makes investing cheap and accessible, leading some in this new generation of retail investors to make risky and uninformed investments.[27] Equally important, the incursion of retail investors into small-cap companies also means that these investors may be unintentionally buying into markedly different governance arrangements, to which many large institutional investors are opposed.

In recent years, scholars have debated the benefits of large investors' push towards market-wide one-size-fits-all governance arrangements.[28] Importantly, we do not take the view that there is a one-size-fits-all governance regime, nor do we discount the value of governance diversity. Instead, we show that even when governance arrangements are viewed as desirable by market participants (regardless of their merit), they are disseminated differently in small-cap companies because the channels of "governance making" in these companies are deficient.

In contrast, when these "governance making" channels operate well, they ensure active engagement and "push and pull" between managers and shareholders, so that powers are spread across constituencies and managers' actions do not remain unchecked. Properly functioning channels do not reduce governance diversity where needed. As the data presented in Part II show, the governance terms of large and visible companies do vary, suggesting that investors in these companies do not always adopt the one-size approach even if they have more power to do so.

This Article proceeds as follows. Part I sets the stage by reviewing the metamorphosis of corporate governance in the United States, highlighting four key

24. John Divine, *How Robinhood Changed an Industry*, U.S. NEWS & WORLD REP. (Oct. 17, 2019, 3:33 PM), https://money.usnews.com/investing/investing-101/articles/how-robinhood-changed-an-industry [https://perma.cc/64S3-AMAL].

25. *See* GARY SHORTER, CONG. RSCH. SERV., IF11663, ROBINHOOD, THE FINTECH DISCOUNT BROKER: RECENT DEVELOPMENTS AND CONCERNS 1 (2020) ("Robinhood had reportedly attracted some 13 million clients with a median age of 31."); Divine, *supra* note 24.

26. *See* SHORTER, *supra* note 25, at 1.

27. *See id.* at 2 (explaining that some experts have expressed concern that firms like Robinhood make risky trades seem too "attractive or low-risk"); Kyle Langvardt & James Fallows Tierney, *On "Confetti Regulation": The Wrong Way to Regulate Gamified Investing*, 131 YALE L.J.F. 717 (2022).

28. *See infra* notes 83-84.

forces that have brought corporate governance to the forefront: regulatory intervention, the rise of institutional investing, the emergence of proxy advisors,[29] and the rise of shareholder activism. But at the same time that "best practice" seems to be omnipresent among large companies, it seems to be absent from a large swath of the public markets. Part I addresses this discrepancy, emphasizing the importance of governance actors in driving governance change and explaining their relative absence and ineffectiveness in smaller companies.

Part II provides a pioneering empirical survey of the differences in governance between large- and small-cap corporations that illustrates what we term the "Corporate Governance Gap." Drawing on a mosaic of rich and diverse data for both Standard & Poor's 1500 (S&P 1500) and Russell 3000 companies, much of it hand-collected and coded, Part II demonstrates the stark disparity in governance terms between the two types of firms over the past twenty years. Part II also provides strong evidence of the dependence of governance making on key actors, showing that investor engagement with companies is concentrated in large-cap corporations.

Part III then moves to the key policy implications of the Corporate Governance Gap. It discusses the concrete steps that regulators, investors, and academics could take to address the disparity in governance arrangements between large and small companies. It also stresses the importance of proxy advisors as one of the few channels that contribute to governance making in smaller companies. These findings are particularly pertinent as calls to restrict proxy advisors' operations have already resulted in regulatory action. Finally, beyond small-scale adjustments in the current corporate ecosystem, Part III recommends broader policy reform aimed at solving the problem of governance making in smaller companies at its root by mandating periodic voting on key governance arrangements.

I. THE RISE OF CORPORATE GOVERNANCE

A. The Changing Corporate Governance Landscape

Corporations influence almost every aspect of our daily lives. Well beyond affecting the 55% of Americans invested in the stock market individually or

29. Proxy advisory firms, such as Institutional Shareholder Services (ISS) and Glass Lewis & Co., play an important role in the capital market. They advise institutional investors how to vote their shares on thousands of matters that companies bring to a vote each year in shareholders' meetings. For a review of the literature that examines proxy advisors' influence on vote outcomes, see Asaf Eckstein & Sharon Hannes, *A Long/Short Incentive Scheme for Proxy Advisory Firms*, 53 WAKE FOREST L. REV. 787, 795-800 (2018).

through retirement funds,[30] corporations wield immense power over everything from the food we eat to the quality of the air we breathe. Corporations engage in lobbying efforts to influence laws,[31] trade with foreign countries,[32] and make decisions about what products are put on shelves and how they are marketed to consumers.

But corporations do not act capriciously. Nor do they make these decisions in a vacuum. The decisions that management and boards make, such as improving diversity,[33] removing firearms from stores,[34] or increasing wages,[35] are guided both implicitly—by the corporation's governance structure, board composition, and sensitivity to shareholder and stakeholder input—and explicitly—by specific corporate governance policies that govern everything from how often the board of directors must meet to how the company can make charitable contributions.[36]

Consequently, shareholders, regulators, and academics have all become increasingly interested in these corporate governance policies, structures, and dynamics. Recognizing how important it is to understand how and why corporations act, they have begun to look behind the curtain. Since the Enron scandal in the early 2000s, the popular media frequently reports on perceived corporate governance failures, which often precipitate further interest in the form of lawsuits and calls for resignations.[37] Countless commissions and organizations have

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30. Teresa Ghilarducci, *Most Americans Don't Have a Real Stake in the Stock Market*, FORBES (Aug. 31, 2020, 9:44 PM EDT), https://www.forbes.com/sites/teresaghilarducci/2020/08/31/most-americans-dont-have-a-real-stake-in-the-stock-market [https://perma.cc/J8E8-NX8L].

31. *See* LEE DRUTMAN, THE BUSINESS OF AMERICA IS LOBBYING: HOW CORPORATIONS BECAME POLITICIZED AND POLITICS BECAME MORE CORPORATE 72-73 (2015).

32. *See* Soulaima Gourani, *Should Businesses Be Open to International Trade?*, FORBES (Aug. 22, 2019, 8:15 PM EDT), https://www.forbes.com/sites/soulaimagourani/2019/08/22/should-businesses-be-open-to-international-trade [https://perma.cc/69W9-ZKPX].

33. *See generally* BOBBY SIU, OPENING DOORS TO DIVERSITY IN LEADERSHIP (2021) (offering strategies to increase diversity in corporate leadership).

34. *See, e.g.*, Sarah Nassauer, *Walmart Pulls Guns, Ammo Displays in U.S. Stores, Citing Civil Unrest*, WALL ST. J. (Oct. 29, 2020, 4:08 PM ET), https://www.wsj.com/articles/walmart-pulls-guns-ammo-displays-in-u-s-stores-citing-civil-unrest-11604002136 [https://perma.cc/QV52-CHR9].

35. *See, e.g.*, Alexa Lardieri, *Costco Raises Minimum Wage to $15 an Hour*, U.S. NEWS & WORLD REP. (Mar. 8, 2019, 11:32 AM), https://www.usnews.com/news/economy/articles/2019-03-08/costco-beats-profit-expectations-raises-minimum-wage-to-15-an-hour [https://perma.cc/HFH5-42MD].

36. Bus. Roundtable, *Principles of Corporate Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 8, 2016), https://corpgov.law.harvard.edu/2016/09/08/principles-of-corporate-governance [https://perma.cc/2S99-X5R4].

37. DAVID LARCKER & BRIAN TAYAN, CORPORATE GOVERNANCE MATTERS: A CLOSER LOOK AT ORGANIZATIONAL CHOICES AND THEIR CONSEQUENCES 1 (1st ed. 2011).

been established to determine corporate governance best practices, often with a goal of bolstering corporate governance across firms.[38] Proxy advisors,[39] which play a pivotal role in corporate governance, have risen in prominence, concentrating on governance metrics in lieu of assessing companies exclusively according to financial performance.[40]

Increased scrutiny of corporate governance has extended beyond merely trying to understand how corporations act. Regulators, investors, proxy advisors, and stock exchanges have all developed a growing interest in both observing and actively shaping corporate governance. As a result, over the last two decades, shareholders have obtained increasing power and influence over their companies' affairs, enabling them to shape corporate governance more than ever before.

This evolution is commonly attributed to several broader changes in the corporate governance landscape over the last twenty years.[41] The first important change came in the form of regulations. Specifically, the Sarbanes-Oxley[42] and Dodd-Frank[43] Wall Street reforms expanded boards' oversight responsibilities and enabled shareholders to gain significant influence over director elections, executive-compensation issues, and governance matters.[44] Similarly, stock exchanges have increasingly demanded improved governance arrangements from

38. *See id.* at 10-13.

39. *See supra* note 29.

40. *See* discussion *infra* Section III.B.

41. Though modern corporate governance has been around since the 1920s, several key changes have transformed both its goals and its prominence over the last few decades. *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2569-75 (2021).

42. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

43. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C.).

44. Matteo Tonello & Matteo Gatti, *Board-Shareholder Engagement Practices*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 30, 2019), https://corpgov.law.harvard.edu/2019/12/30/board-shareholder-engagement-practices [https://perma.cc/9JL2-26Z9]; Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 827-29.

their listed members, from increased director independence[45] to mandated shareholder approvals[46] to greater board diversity.[47]

A second significant change that took place over the last two decades is the steady increase in the influence of institutional investors, who today control the majority of the shares of U.S. public companies.[48] As a result, institutional investors have become powerful players with a dominant impact on vote outcomes in the most significant public companies.[49] In recent years, these investors have been willing to harness that power, increasingly supporting corporate governance changes.[50] Along with their evolving role in voting outcomes, institutional investors are becoming increasingly active owners by engaging in dialogue with portfolio companies in an effort to improve environmental, social, and corporate governance performance. For example, BlackRock, one of the largest institutional investors in the country, recently released a 2021 Stewardship Expectations document indicating its heightened willingness to vote against companies in shareholder proposals, its commitment to supporting board ethnic and gender diversity, and its increased focus on management compensation.[51]

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45. N.Y. STOCK EXCH., N.Y.S.E. LISTED COMPANY MANUAL §§ 303A.01, -.04 to -.06 (2021), https://nyse. wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-69 [https://perma.cc/F4QK-2SW3]; NASDAQ, THE NASDAQ STOCK MARKET LLC RULES § 5605(b)(1), (c)(2), (d)(2), (e) (2021), https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/Nasdaq%205600%20Series [https://perma.cc/88CX-JMQ7].

46. N.Y. STOCK EXCH., *supra* note 45, § 312.03.

47. Alexander Osipovich & Akane Otani, *Nasdaq Seeks Board-Diversity Rule that Most Listed Firms Don't Meet*, WALL ST. J. (Dec. 1, 2020, 5:26 PM ET), https://www.wsj.com/articles/nasdaq-proposes-board-diversity-rule-for-listed-companies-11606829244 [https://perma.cc/W5Y7-SJ7X].

48. Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 725-26 (2019); Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 365 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 874-75 (2013); Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSPS. 89, 91 (2017).

49. Bebchuk & Hirst, *supra* note 48, at 732-40 (documenting that the "Big Three" collectively vote about 25% of the shares in all S&P 500 companies and that stock held by index funds has risen dramatically over the past two decades and can be expected to continue growing).

50. Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, 94 S. CAL. L. REV. 569, 575 (2021).

51. *Our 2021 Stewardship Expectations: Global Principles and Market-Level Voting Guidelines*, BLACKROCK (2021), https://www.blackrock.com/corporate/literature/publication/our-2021-stewardship-expectations.pdf [https://perma.cc/4ZFZ-WJF7].

A third development in the evolving corporate governance landscape is the rise of proxy advisors. Since the 1980s,[52] proxy advisory firms have exerted increasing influence over a wide range of corporate governance topics by advising shareholders on how to vote in director elections and on shareholder proposals.[53] Many investors, large and small, trust and often follow the voting recommendations of proxy advisory firms. For example, BlackRock recently acknowledged that while it works diligently to research and develop its own position on votes, it relies heavily on proxy advisory firms such as Institutional Shareholder Services (ISS), admitting that the firm can "have significant influence over the outcome of both management and shareholder proposals."[54] The former Chief Justice of the Delaware Supreme Court, Leo E. Strine, aptly characterized proxy advisors' influence:

> [P]owerful [Chief Executive Officers (CEOs)] come on bended knee to Rockville, Maryland, where ISS resides, to persuade the managers of ISS of the merits of their views about issues like proposed mergers, executive compensation, and poison pills. They do so because the CEOs recognize that some institutional investors will simply follow ISS's advice . . . .[55]

Finally, a fourth significant development in the U.S. capital markets is the rise of activist hedge funds. These are savvy, sophisticated investors that take large but noncontrolling stakes in target companies to bring about change in the target companies' strategic, operational, and financial activities as well as their governance arrangements.[56] Many scholars consider the emergence of activist

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52. *See About ISS*, ISS (2021), https://www.issgovernance.com/about/about-iss [https://perma.cc/AQW7-KTCL].

53. Frank M. Placenti, *Are Proxy Advisors Really a Problem?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 7, 2018), https://corpgov.law.harvard.edu/2018/11/07/are-proxy-advisors-really-a-problem [https://perma.cc/6P9B-BJUU].

54. Barbara Novick, Michelle Edkins, Tom Clark & Alexis Rosenblum, *The Investment Stewardship Ecosystem*, BLACKROCK 6 (July 2018), https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-investment-stewardship-ecosystem-july-2018.pdf [https://perma.cc/VW53-MH9D].

55. Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 688 (2005). For a review of the literature that examines proxy advisors' influence on vote outcomes, see Eckstein & Hannes, *supra* note 29.

56. For the main characteristics of hedge funds, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1734-36 (2008). For a discussion of the range of operational and financial changes sought by activists, see *id.* at 1741-45. *See also* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029 (2007) (describing the basic goals and tactics of activist hedge funds). *See generally* Lucian A. Bebchuk, Alon Brav, Wei hedge funds a groundbreaking shift in the corporate governance of public firms.[57]

The cumulative effect has been a metamorphosis of corporate governance. Not only do investors increasingly care about how the companies in which they invest govern themselves and make decisions, but they have been increasingly *willing* and *able* to shape these governance arrangements.[58]

Though these recent changes in the corporate governance landscape and the rise in shareholder engagement should be celebrated, a closer look exposes a lack of coherence in companies' corporate governance practices. Corporate governance arrangements are not monolithic. In fact, the so-called metamorphosis of corporate governance has significantly affected only the large companies operating in the public eye. Take, for example, Fresh Del Monte Products, a small fruit-and-vegetable supply company in the S&P Small-Cap 600 (S&P 600). Fresh Del Monte operates without any of the putative markers of what investors often consider to be good governance practice. Not only is its board classified,[59] effectively protecting it from shareholder takeovers, but the CEO also acts as the chair.[60] While the company has a lead independent director position, only three very limited powers are allocated to the position.[61] The board also lacks a nominating

Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1 (2020) (providing a comprehensive analysis of the drivers, nature, and consequences of activists' engagements and settlements with companies).

57. *See, e.g.*, Frank Partnoy & Randall Thomas, *Gap Filling, Hedge Funds, and Financial Innovation*, *in* NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHALLENGES 101, 101 (Yasuyuki Fuchita & Robert E. Litan eds., 2007) (observing that activist hedge funds "have shaken up boardrooms and forced radical changes at many publicly-traded firms"). Jonathan R. Macey, for instance, claimed that hedge funds and private equity firms "are the newest big thing in corporate governance" and that they "actually deliver on their promise to provide more disciplined monitoring of management." JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 241, 272 (2008). Marcel Kahan and Edward B. Rock expressed hope that activist hedge funds "may act 'like real owners' and provide a check on management discretion." Kahan & Rock, *supra* note 56, at 1047.

58. *See* Kastiel & Nili, *supra* note 50, at 578-79; Kobi Kastiel & Yaron Nili, *Competing for Votes*, 10 HARV. BUS. L. REV. 287, 297-98, 309-15 (2020).

59. *2021 Proxy Statement*, FRESH DEL MONTE PRODUCE INC. 11 (Mar. 23, 2021), http://investorrelations.freshdelmonte.com/sec-filings/sec-filings-details/default.aspx?FilingId=14820189 (download proxy statement) [https://perma.cc/48CC-KH7C].

60. *Id.* at 19-20.

61. *Id.* at 19.

committee.[62] This structure remains in place without shareholder proposal challenges,[63] and shareholders lack the ability to call a special meeting.[64]

Fresh Del Monte is no outlier. As we show in Part II, outside the S&P 500, a whole universe of companies hovers just below the radar, subject to few of the disciplinary forces shaping the governance of larger companies. These companies operate in a no-man's-land. For example, small-cap companies are approximately ten years behind large-cap companies in terms of board gender diversity.[65] Voting standards employed in director elections also vary significantly based on company size. In 2019, approximately 41% of Russell 3000 companies still retained a simple plurality voting system.[66] Conversely, only 9.6% of S&P 500 companies have retained a plurality voting system.[67] Yet another corporate governance metric dictated by company size is board classification. Among Russell 3000 companies, 41.2% have classified boards, compared with 10.9% of S&P 500 companies.[68]

These profound differences in governance practices are important. A large body of empirical evidence demonstrates the significance of governance provisions for firm valuation[69] and better corporate decision-making,[70] as well as the importance of active engagement by shareholders to ensure that managers' actions do not remain unchecked.[71] Poor governance practices, and the governance of small firms more specifically, were similarly found to be associated with a high

62. *Id.* at 21-22. For a further discussion of committees, see Nili & Hwang, *supra* note 1, at 1110-16.

63. *See 2021 Proxy Statement*, *supra* note 59, at 70.

64. *Fresh Del Monte Produce Inc. Corporate Governance Provisions*, FACTSET (Oct. 2021), [https://perma.cc/2V3L-FPGD].

65. Madison Sargis, *Few, but Increasing, Signs of Gender Diversity on Corporate Boards*, MORNINGSTAR 2 (Feb. 28, 2019), https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/Corporate-Board-Gender-Diversity.pdf [https://perma.cc/M9NH-66KV].

66. Matteo Tonello, *Corporate Board Practices in the Russell 3000 and S&P 500: 2020 Edition*, THE CONF. BD. 15 (2020), https://conferenceboard.esgauge.org/assets/Corporate%20Board%20Practices%202020%20Edition.pdf [https://perma.cc/8J3J-BWA8].

67. *Id.*

68. *Id.* at 16.

69. *See, e.g.*, sources cited *infra* notes 197-199, 208, and 215-216.

70. Merritt B. Fox, Ronald J. Gilson & Darius Palia, *The Core Corporate Governance Puzzle: Contextualizing the Link to Performance*, 99 B.U. L. REV. 1995, 2040, 2053 (2019) ("Our full sample OLS results suggest that governance structures associated with good ratings, by filtering out bad managers and/or providing more effective managerial incentives, are consistent with better corporate decision-making and hence, over time, higher cash flows available for shareholders . . . . [O]n average across all firms and time periods, firms that score more favorably with respect to these various governance attributes would create more value.").

71. *See, e.g.*, sources cited *supra* note 57; sources cited *infra* notes 95-98.

incidence of fraud and noncompliance.[72] And even those who hold the opposite view, that governance provisions that enhance managerial accountability to shareholders in fact harm firm value,[73] are likely to be interested in understanding how governance provisions are disseminated in the market, as well as the impact of firm size on investor attention and the adoption of governance arrangements by public firms.

This significant landscape of disparate corporate governance elements that we carefully assemble in Part II also demands a reconciliation. How can one explain the growth of more responsible corporate governance practices in large firms in light of its seeming absence in small and mid-size public companies? Understanding how the channels of "corporate governance making" operate is a crucial first step in answering this question. Below, we explain why governance arrangements are likely to differ across companies.

B. Corporate Governance Is Not Self-Driven

What drives the difference in the diffusion of corporate governance standards among publicly traded firms? This Section concludes that corporate governance is not self-driven. It requires *private* forces of implementation, and those are more prevalent at large-cap corporations.

1. *Private Ordering as a Driving Force*

Corporate governance development is driven primarily by "private ordering."[74] In the context of corporate law, private ordering means that firms choose governance practices that fit their needs, as opposed to complying with mandatory laws setting governance standards.[75] The entire structure of U.S. corporate

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72. *See* Brian J. Bushee, Mary Ellen Carter & Joseph Gerakos, *Institutional Investor Preferences for Corporate Governance Mechanisms*, 26 J. MGMT. ACCT. RSCH. 123, 146 (2014); *see also* Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371, 404 (2005) ("[I]ndependent directors with financial expertise are valuable in providing oversight of a firm's financial reporting practices."); William R. Baber, Sok-Hyon Kang, Lihong Liang & Zinan Zhu, *External Corporate Governance and Misreporting*, 32 CONTEMP. ACCT. RSCH. 1413, 1416 (2015) (finding that strong external governance, as reflected by fewer restrictions on shareholder participation, is associated with relatively low probabilities of accounting restatements).

73. *See, e.g.*, sources cited *infra* note 119.

74. "Private ordering" refers to private actors creating and enforcing private rules. *See generally* Michal Barzuza, *Inefficient Tailoring: The Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. 131 (2018) (providing an overview and critical assessment of reliance on private ordering).

75. *See id.* at 132-33.

law is mostly enabling, generally offering firms a set of default rules that they can adopt or reject.[76] With most of corporate law made at the state level, state corporate law is the key source of internal governance matters.[77] While certain provisions of state corporate law may be mandatory, most of them are discretionary and leave considerable room for private ordering.[78] Corporations can opt out of the permissive provisions or reincorporate in another state if they are unhappy with the mandatory terms of state corporate law.[79] Indeed, that feature of U.S. corporate law, whereby states may design their own corporate rules, has spawned rich debate about the value and hazards of such competition for incorporation.[80]

Due to the lack of federal regulation and state corporate law, the primary driver of corporate governance is private ordering. While Congress has recently attempted to reform corporate regulation with the Sarbanes-Oxley Act[81] and the Dodd-Frank Act,[82] these statutes and their corresponding regulations are highly specific and narrowly tailored. In fact, these Acts are the exception rather than the rule regarding governance regulation. Firms are allowed, in most instances, to choose their governance structure when incorporating and thereafter adjust it as they see fit.

Prominent scholars have long argued for the use of private ordering as the most appropriate way to tie governance structure to the specific characteristics

76. For a discussion of the enabling structure of U.S. corporate law, see, for example, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 1 (1993); and Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441, 443 (2014).

77. *See, e.g.*, DEL. CODE ANN. tit. 8 (2017); MODEL BUS. CORP. ACT (AM. BAR ASS'N 2017); James D. Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 257-92 (2015).

78. *See* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227, 229 (2018).

79. *See* Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 263 (1980); *see also* Barzuza, *supra* note 74, at 166-75 (explaining Nevada's recent increase in out-of-state incorporations and lax corporate law).

80. *See, e.g.*, Frank H. Easterbrook, *The Race for the Bottom in Corporate Governance*, 95 VA. L. REV. 685, 691-706 (2009); Kathryn N. Fine, *The Corporate Governance Debate and the ALI Proposals: Reform or Restatement?*, 40 VAND. L. REV. 693, 695-700 (1987).

81. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C. (2018)).

82. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 and 15 U.S.C. (2018)).

and needs of the firm.[83] The major argument against mandatory regulation is that not all companies need the same governance constraints.[84] Others, however, have expressed serious concerns that private ordering frequently leads to inefficient results, whereby firms that need governance constraints are precisely the ones that do not volunteer to implement them.[85] They have also argued that firms' managers might have an incentive to include antitakeover arrangements in the company's incorporation documents, enabling them to fully capture the benefits of such protection and bear only part of the cost of the reduced share price.[86]

In this Article, we do not take a position as to whether private ordering is superior to mandatory regulation. Rather, our claim is that private ordering

83. *See, e.g.*, ROMANO, *supra* note 76, at 1 ("The genius of American corporate law is in its federalist organization. . . . Firms . . . can particularize their charters under a state code, as well as seek the state whose code best matches their needs so as to minimize their cost of doing business."); Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1098-99 (2008) ("That is corporate law apple pie and motherhood, with the kind of private ordering that is central to the American form of corporate lawmaking being preeminent in the outcome. That is, the market . . . will have the most important role in establishing the norms, with flexibility for particular corporations to deviate from those norms in ways that work for them."); MACEY, *supra* note 57, at 103 ("[A]n advantage of private sector ordering in determining the composition of boards is that private ordering can adjust board composition to reflect the efficacy of complementary corporate governance mechanisms.").

84. *See, e.g.*, Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 774 (2017) ("[L]awmakers—including courts, regulators, and legislators—should avoid one-size-fits-all solutions."); Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. REV. 1057, 1063 (2019) ("We believe however that, as with many other debates over good corporate governance, a one-size-fits-all approach is overly simplistic.").

85. Michal Barzuza, *Inefficient Tailoring: The Private Ordering Paradox in Corporate Law*, 8 HARV. BUS. L. REV. 131, 131 (2018) (providing empirical evidence supporting this claim); *see also* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 592, 612-17 (2017) (explaining "why public officials and investors cannot rely on private ordering to eliminate dual-class structures that become inefficient with time"); Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1329 (2013) (finding close to zero innovation or customization in a hand-collected sample of initial public offering (IPO) charters and bylaws); Stephen J. Choi, Jill E. Fisch, Marcel Kahan & Edward B. Rock, *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1123-24 (2016) (providing evidence that investors, perhaps counterintuitively, may have employed a strategy of targeting shareholder-responsive firms first, rather than focusing on those companies most in need of governance reform).

86. *See, e.g.*, Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 719-20 (2003) (discussing managers' perverse incentives); Klausner, *supra* note 85, at 1370 (raising doubts regarding whether manager-founders and other pre-IPO shareholders incur a cost when they take companies public with antitakeover arrangements).

works well only if there are no barriers for initiating governance changes when necessary, and that this is far from being the case with small firms.

2. *The Limits of Private Ordering*

Both state and federal law generally defer to companies' choices regarding their internal affairs and governance arrangements. Companies choose their preferred governance arrangements at the initial public offering (IPO) stage.[87] At least in theory, if managers select a default arrangement that is less favorable to shareholders at the IPO stage, shareholders can try to initiate governance changes by submitting shareholder proposals.[88] Moreover, institutional changes in the market that have taken place over the past two decades—including the ability of proxy advisors to enhance coordination among investors and to sanction management for a failure to act on a proposal that received majority support—have also led management to be more responsive to shareholder demands in the post-IPO stage.[89]

This dynamic, however, is mostly relevant to *large* firms. The analysis we present in this Section clarifies why institutional investors and activist shareholders have limited incentives and resources to engage with small firms. Essentially, the ability to change a default arrangement adopted at the IPO stage is more limited in smaller companies, and private ordering is less likely to work effectively in these firms. Moreover, small firms are more likely to have a shareholder who controls the outcome of shareholder votes, making it more difficult to initiate governance changes with which the controlling shareholder disagrees.[90] Finally, small firms also have less robust disclosures in place, making

87. In some cases, companies already put in place dual-class structures and set other governance arrangements while private, especially with the rise of unicorns (the term "unicorn" captures the elusive and rare nature of megahit ventures in a fund that are worth a billion dollars or more). *See* Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 157, 182 (2019). Still, these companies do go through a market check during the IPO process. *Id.* at 220.

88. For a general formulation of the argument that IPO pricing reflects the quality of offered governance, see Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 128-31 (1987); and Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2366-67 & n.16 (1998). For studies that criticize such approaches, see sources cited *supra* notes 85-86.

89. *See* Klausner, *supra* note 85, at 1362. For a review of the empirical literature on the negative consequences of a withhold vote for directors, see Kastiel & Nili, *supra* note 50, at 606.

90. *See, e.g.*, Kosmas Papadopoulos, *CEO Ownership, Corporate Governance, and Company Performance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 13, 2019), https://corpgov.law.harvard.edu/2019/05/13/ceo-ownership-corporate-governance-and-company-performance [https://perma.cc/Q8ZP-4D5Z] ("According to ISS data, controlled companies make up only 3.6 percent of S&P 500 and 8.4 percent of the entire Russell 3000.").

their governance arrangements less salient. Together, these obstacles explain why company size has a detrimental effect on the effectiveness of private ordering, and consequently on the development of effective governance.

a. Engagement by Institutional Investors

Major shareholders have begun to leverage their increased voting power[91] to demand greater involvement in business decision-making and governance arrangements through direct engagement with portfolio companies, both privately and publicly.[92] The term "engagement" encompasses a range of investor activities, communications, and discussions with companies, including email and letter exchanges, phone calls, and individual meetings with board members.[93] Furthermore, engagement serves as a significant incentive tool, encouraging the board to set policies and practices that better reflect shareholder interests in advance.[94]

Engagement is not a one-way street. It has flourished in recent years with companies also expressing a strong interest in pursuing shareholder engagement.[95] Increased board-shareholder communication can help promote a better understanding of company policies among investors and prevent the negative repercussions of shareholder activism. By enhancing their engagement with

91. *See* Kastiel & Nili, *supra* note 58, at 297.

92. Brian V. Breheny, *Can We Talk? The Continuing Demand for Shareholder Engagement*, 14 CORP. GOVERNANCE REP. 48, 48-51 (2011).

93. *See* Assaf Hamdani & Sharon Hannes, *Institutional Investors, Activist Funds and Ownership Structure*, *in* COMPARATIVE CORPORATE GOVERNANCE 368, 374 (Afra Afsharipour & Martin Gelter eds., 2021); LISA M. FAIRFAX, SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION 115-16, 122 (2011); Matthew J. Mallow & Jasmin Sethi, *Engagement: The Missing Middle Approach in the Bebchuck-Strine Debate*, 12 N.Y.U. J.L. & BUS. 385, 393 (2016); Michelle Edkins, *The Significance of ESG Engagement*, *in* 21ST CENTURY ENGAGEMENT: INVESTOR STRATEGIES FOR INCORPORATING ESG CONSIDERATIONS INTO CORPORATE INTERACTIONS, BLACKROCK & CERES 4 (May 28, 2015), https://www.ceres.org/sites/default/files/reports/2017-03/21st%20Century%20Engagement%20-%20Investor%20Strategies.pdf [https://perma.cc/T2TV-CQQQ].

94. James Kim & Jason D. Schloetzer, *Global Trends in Board-Shareholder Engagement*, CONF. BD. DIR. NOTES 2 (Oct. 2013), https://www.conference-board.org/publications/publicationdetail.cfm?publicationid=2618 [https://perma.cc/6J3T-Y6P5].

95. Hamdani & Hannes, *supra* note 93, at 372-73.

shareholders, directors can better ascertain shareholder perspectives and concerns, and ultimately avoid contentious battles.[96] Moreover, effective shareholder engagement can increase investor trust and translate into greater shareholder support for corporate practices.[97]

Given these advantages, it is not surprising that engagement has been adopted by large institutional investors as a key tool for overseeing management conduct and effectuating change in their portfolio companies.[98] While in 2010, a mere 6% of S&P 500 companies reported engagement with major investors, this figure climbed to 72% in 2017, and it has continued to grow since then.[99] In 2019, 91% of Fortune 100 companies disclosed engagement with investors, up from 82% three years earlier.[100]

Nevertheless, these engagement patterns are not uniform across companies, and small firms are less likely to receive attention from large institutional investors compared to large- or mid-size firms. For example, José Azar and his colleagues examined the role of the "Big Three"—BlackRock, State Street Global Advisors, and Vanguard—in reducing corporate carbon emissions around the world.[101] Using data on engagement of the Big Three with public firms in the period between 2005 and 2018, they found evidence that large investors focus

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96. David R. Beatty, *How Activist Investors Are Transforming the Role of Public-Company Boards*, McKinsey & Co. (Jan. 3, 2017), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/how-activist-investors-are-transforming-the-role-of-public-company-boards [https://perma.cc/U9GG-MB4U].

97. Fairfax, *supra* note 44, at 833-34; Mallow & Sethi, *supra* note 93, at 393-94.

98. *See* Bebchuk & Hirst, *supra* note 48, at 725-26.

99. EY Ctr. for Bd. Matters, *2017 Proxy Season Review*, Ernst & Young 4 (2017), https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/Alert%20PDF's/2017%20PDFs/EY%202017%20proxy%20season%20review.pdf [https://perma.cc/FDK8-SDZ4].

100. EY Ctr. for Bd. Matters, *Five Takeaways from the 2019 Proxy Season*, Ernst & Young 6 (July 2019), https://assets.ey.com/content/dam/ey-sites/ey-com/en_us/topics/cbm/ey-cbm-2019-proxy-season-preview.pdf [https://perma.cc/7JQ9-VHDJ]; *see also Investment Stewardship 2019 Annual Report*, Vanguard 8 (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/2019_investment_stewardship_annual_report.pdf [https://perma.cc/2GRN-SF45] ("We engaged with 868 companies, up from 721 in 2018, as we met with more companies outside the U.S. These engagements reflected 59% of our global equity assets under management."); *BlackRock Investment Stewardship 2018 Annual Report*, BlackRock 7 (Aug. 30, 2018), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2018.pdf [https://perma.cc/3NMA-5MMH] ("We participated in 2,049 company engagements with 1,453 companies this past year. . . . This year we engaged in 34 countries, many outside the traditional engagement universe, including in Brazil, China, India, Mexico, South Africa, Singapore and Taiwan.").

101. José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions Around the World*, 142 J. Fin. Econ. 674, 678-92 (2021).

their engagement efforts on the largest firms in which they hold a significant stake.[102]

But why do investors tend to engage with large firms, rather than small ones? As studies show, in order to keep their fees low, investors, especially index funds, with limited resources and incentives to invest in engaging with public firms must prioritize their targets and resources.[103] Accordingly, Lucian Bebchuk and Scott Hirst reported that the Big Three engage with a very small proportion of their portfolio companies, and only a small proportion of portfolio companies have more than a single engagement in any year.[104] When investors do engage with portfolio companies, they tend to prefer large-capitalization companies, rather than small ones.[105] In the case of small firms, the costs of engagement are somewhat the same, but the potential benefits from such activities are reduced, given that they represent a smaller fraction of the portfolio of institutional investors. For this reason, institutional investors do not have adequate incentives to invest resources in engaging with and changing the governance structure of small companies.

This conclusion is supported by recent evidence we hand collected on the engagement patterns of the three largest passive index funds during the years 2018-2020. As Section II.B shows, the Big Three predominantly engage with S&P 500 companies, with little engagement with small-cap companies.

b. Shareholder Proposals

Shareholder activism in the form of shareholder proposals also plays a key role in generating corporate governance changes. Under Rule 14a-8 of the Security and Exchange Act of 1934, all shareholders have the right to submit a proposal to effectuate a specific corporate governance change.[106] Although shareholder-proposal votes are nonbinding, companies often adopt proposals that

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102. *Id.* at 681. The Big Three engage much more often with the firms included in MSCI World Index (48%) compared to the firms not included in the index (15%). *Id.* Similarly, the number of engagements is substantially higher among MSCI firms than among non-MSCI firms in absolute terms (625 and 275, respectively). *Id.*

103. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2050-59 (2019).

104. *Id.* at 2039, 2087-88.

105. *Id.* at 2088-89.

106. Shareholder proposals are governed by Rule 14a-8 of the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78qq (2018)), which permits shareholders to force the company to include a resolution in its own proxy materials subject to certain requirements. 17 C.F.R. § 240.14a-8 (2020).

have received significant shareholder support to avoid public criticism and investor backlash.[107] In theory, corporations' largest investors—the titans of Wall Street—are better positioned than any other shareholders to set market-wide governance standards and submit these proposals. Recent empirical evidence, however, shows that they refrain from this activity. In fact, the Big Three have failed to submit a single shareholder proposal over the past decade.[108]

The absence of most institutional investors from the shareholder-proposal arena has left the playing field to individual investors and nonprofit watchdogs.[109] However, the submission of shareholder proposals, especially if widespread, can prove a costly activity for individual investors who submit the majority of shareholder proposals.[110] These individuals must devote time and resources to preparing and submitting shareholder proposals, as well as to attending the various shareholder meetings in person.

Moreover, the submission of proposals on a large scale requires a financial stake in a large number of companies simultaneously. Such a portfolio is trivial for institutional investors. However, holding positions in a large number of companies can be expensive and requires significant resources for individual investors, who typically have access only to their personal wealth.[111]

Finally, the amended Rule 14a-8 of the Securities Exchange Act of 1934 places additional barriers that render these strategies even more difficult, if not impossible. According to the amended rule, for individuals to maintain eligibility to table proposals, they must either increase their investments tenfold to $25,000 per company, or they must lock up their smaller, $2,000 investment in a company for at least three years, while also delaying their ability to suggest governance changes in new companies in their portfolio.[112] Perhaps an even greater

107. Kastiel & Nili, *supra* note 50, at 606-07.

108. Bebchuk & Hirst, *supra* note 103, at 2039-40.

109. *See, e.g.*, AS YOU SOW, http://www.asyousow.org [https://perma.cc/7AZ9-BCRD]; *see also* Roberto Tallarita, *Stockholder Politics*, 73 HASTINGS L. J. (forthcoming 2022) (providing a comprehensive review of the submission of socially relevant proposals by a small number of specialized players).

110. *See* Kastiel & Nili, *supra* note 50, at 590-99, 610-11.

111. Not surprisingly, some gadflies come from wealthy families or cooperate with each other in order to sustain this costly activity. For instance, noted activist Evelyn Y. Davis's tax filings show her charitable foundation had assets of more than $11 million at the end of 2017. Emily Flitter, *Evelyn Y. Davis, Shareholder Scourge of C.E.O.s, Dies at 89*, N.Y. TIMES (Nov. 7, 2018), https://www.nytimes.com/2018/11/07/business/evelyn-davis-dead.html [https://perma.cc/8A89-JJGR].

112. 17 C.F.R. § 240.14a-8 (2020).

barrier is that the rule, reversing a longstanding tradition, now prohibits individual investors from aggregating their holdings to meet eligibility thresholds.[113]

As a result of the cost and time investment required, individual investors target only a limited number of companies. Indeed, evidence shows that a group of activist retail investors, often termed "corporate gadflies," tend to sponsor shareholder proposals at much larger companies, mostly those in the S&P 500, which may attract and be more sensitive to public opinion.[114] But this leaves thousands of companies, mostly small- and mid-cap companies, untouched.[115]

This analysis is supported by data we provide in Section II.B.2, showing that larger companies received the vast majority of shareholder proposals. For example, in 2015, over 450 proposals were submitted to companies in the S&P 500, which is comprised of large-cap companies. In contrast, fewer than 150 shareholder proposals were submitted to the small and mid-cap companies that comprise the S&P Mid-Cap 400 (S&P 400) and S&P 600, respectively.

Thus, ironically, in the existing governance ecosystem, those with resources (large institutional investors) tend to avoid submitting proposals, and those who actually do submit the majority of the proposals (individual shareholders) lack

113. Allison Herren Lee, *Statement on the Amendments to Rule 14a-8*, U.S. SEC. & EXCHANGE COMM'N (Sept. 23, 2020), https://www.sec.gov/news/public-statement/lee-14a8-2020-09-23 [https://perma.cc/R8WP-RKRY].

114. Moreover, since large companies receive more proposals prior to the annual meeting compared to small companies, it is easier for a gadfly to demand that another shareholder proponent present the gadfly's proposal at the meeting, with no additional cost. Our finding regarding gadflies' tendency to focus on large companies is consistent with existing empirical evidence showing that proponents target large American companies rather than those that would benefit most. *See* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368, 376 (2007); Tara Bhandari, Peter Iliev & Jonathan Kalodimos, *Governance Changes Through Shareholder Initiatives: The Case of Proxy Access*, 56 J. FIN. & QUANTITATIVE ANALYSIS 1590, 1590-94 (2021) (finding that the adoption of shareholder proposals is concentrated at large firms that already have strong governance practices); Kosmas Papadopoulos, *The Long View: The Role of Shareholder Proposals in Shaping U.S. Corporate Governance (2000-2018)*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 6, 2019), https://corpgov.law.harvard.edu/2019/02/06/the-long-view-the-role-of-shareholder-proposals-in-shaping-u-s-corporate-governance-2000-2018 [https://perma.cc/Q86P-ZVZY] (explaining empirical data that show that 75% of shareholder proposals were submitted to S&P 500 companies in 2018, aligning with the average level of 77% throughout the last decade).

115. *See Shareholder Advocate Newsletter: Interview with BU Law Professor David Webber on Efforts to Limit Shareholder Proposals*," COHEN MILSTEIN (July 20, 2017), https://www.cohenmilstein.com/update/%E2%80%9Cinterview-bu-law-professor-david-webber-efforts-limit-shareholder-proposals%E2%80%9D-shareholder [https://perma.cc/XVX8-MB6Z] ("The reality is that very few companies face shareholder proposals in any given year. . . . [O]nly 1-3% of all public companies . . . receive a shareholder proposal per year.").

the resources to do so on a large scale. This, again, leaves private ordering limited, if not entirely lacking, in smaller corporations.

c. *Hedge-Fund Activism*

Hedge-fund activism has reached record highs in recent years.[116] In 2019, activist hedge funds such as Pershing Square Holdings, JANA Partners, and Blue Harbour Group enjoyed returns that substantially outperformed the market.[117] Companies and their shareholders, however, experience this engagement in decidedly different ways according to their size. The size and expertise of the activist, coupled with the activist's ability to dedicate time and resources to achieving its targeted goal, can have a dramatic impact on whether a company adopts the requested change.[118]

Many scholars considered the emergence of activist hedge funds, which can fill the monitoring gap created by rationally apathetic shareholders, as a groundbreaking shift in the corporate governance of public firms. While the value of hedge-fund activism is still a hotly contested topic,[119] one thing is clear: activist

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116. Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 20, 2020), https://corpgov.law.harvard.edu/2020/01/20/dealing-with-activist-hedge-funds-and-other-activist-investors-3 [https://perma.cc/8NQM-673L].

117. *See* Carmen Reinicke, *Billionaire Bill Ackman's Hedge Fund Delivered 58% Returns in 2019 After Making a Big Investment in Warren Buffett's Berkshire Hathaway*, INSIDER (Jan. 7, 2020, 10:39 AM), https://markets.businessinsider.com/news/stocks/bill-ackman-pershing-square-outperformed-returns-2019-berkshire-warren-buffett-2020-1 [https://perma.cc/DZ27-D92Y]; Svea Herbst-Bayliss, *Jana Partners' Activist Fund Gains 52% as Bets Such as ConAgra Pay Off*, REUTERS (Jan. 6, 2020, 6:12 PM), https://www.reuters.com/article/hedgefunds-jana/jana-partners-activist-fund-gains-52-as-bets-such-as-conagra-pay-off-idUSL1N29B1S1 [https://perma.cc/6PWP-RHMP]; Paul Schott, *Greenwich Hedge Fund Blue Harbour Set to Close*, CT INSIDER (March 2, 2020, 3:53 PM), https://www.ctinsider.com/business/greenwichtime/article/Greenwich-hedge-fund-Blue-Harbour-set-to-close-15099459.php [https://perma.cc/3FL8-6DHV].

118. *See* discussion *infra* Section II.B.

119. For the debate regarding activist hedge funds' value creation, see generally Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637 (2013), which argues that insulating boards from shareholder pressure does not serve the long-term interests of companies and their shareholders; Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE. L.J. 1554 (2015), which questions the view that a firm's managers should favor long-term shareholders over short-term shareholders; and Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977 (2013), which argues that corporate lawmakers should not attempt to further shield managers and boards from shareholder influence. Critics of hedge-fund activism claim that hedge-fund interventions are value decreasing in the long term and that activists tend to use their power to force hedge funds are increasingly important players in the corporate governance arena. But to what extent has the rise of activist hedge funds impacted small firms? Ostensibly, small companies are likely to be easier and more attractive targets for hedge-fund activism compared to larger corporations. Hedge funds are sophisticated investors that take large, but noncontrolling, stakes in purportedly underperforming target companies to bring about change in the target companies' strategic, operational, or financial activities.[120] It is more expensive for an activist hedge fund to amass a large enough stake to engender change if a company has a large market cap.[121]

However, the analysis does not end here. There are also disadvantages of engaging with small firms. First, small firms have relatively less liquid stock than large firms do, which creates hurdles to accumulating a large nonmajority position and then selling it once the hedge fund is willing to exit. Second, because these companies face lower levels of public scrutiny and media coverage, engagements with them will receive less attention, which may not satisfy the hedge fund's interests.[122] Small companies also have a lower percentage of institutional ownership and a higher percentage of retail investors, who tend not to participate in the voting process.[123] All of the above suggests that corporations experience hedge-fund activism in different ways based on their size, liquidity, and the degree of public scrutiny they receive.

Importantly, outcomes of hedge-fund activism are also a function of the hedge fund involved in any given campaign. Here, again, stark differences between funds can be identified. Highly funded, reputable activists may gravitate

management to disgorge cash in lieu of investing in long-term growth. For studies invoked by critics of hedge-fund activism, see Martin Lipton, *Is 2015, Like 1985, an Inflection Year?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 8, 2015), http://corpgov.law.harvard.edu/2015/12/08/is-2015-like-1985-an-inflection-year [https://perma.cc/M8ET-ENP6]. Other scholars find that the empirical evidence with respect to long-term gains is mixed and any conclusion that hedge-fund activism is efficiency enhancing is still premature. *See, e.g.*, John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 576, 586-87 (2016).

120. *See* discussion *infra* Section II.B.

121. *See, e.g.*, Francis J. Aquila, *In Review: Recent Trends in Shareholder Activism in USA*, LEXOLOGY (Oct. 15, 2020), https://www.lexology.com/library/detail.aspx?g=c024090f-9a57-4eb9-b4b7-04b429b0ae21 [https://perma.cc/MP6W-F74Z] ("A company's . . . market cap can play a role in its susceptibility to activism; it is inherently more difficult for a shareholder activist to amass a large enough stake to influence a company with . . . a large market cap.").

122. *See infra* Section I.C.2.

123. *See, e.g.*, Kobi Kastiel & Yaron Nili, *In Search of the "Absent" Shareholders: A New Solution to Retail Investors' Apathy*, 41 DEL. J. CORP. L. 55, 60-69 (2016) (documenting retail investors' low participation rates in shareholder votes); Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 14-16 (2017) (same).

toward engagements with large companies because engagement with such companies is likely to provide public attention and a large windfall. Additionally, such funds have the resources required to win proxy contests in these companies. In contrast, smaller, less experienced, and less resourceful hedge funds may focus on small companies. Such differences could affect the quality of the engagements in addition to the likelihood of their success.[124]

To illustrate this point, consider the following examples. Recently, in "one of America's most bitter proxy contests," Trian Fund Management targeted Procter & Gamble (P&G) in a ten-month-long campaign to nominate Nelson Peltz to the board of directors in response to P&G's lagging shareholder returns and stagnating sales.[125] Trian's strategy was simple but direct; the activist had done its research before engaging, identified what it wanted to change, and stuck to its strategy.[126] Interestingly, in affirming its commitment to P&G's long-term success, Trian devoted an entire section of its white paper to how it would improve P&G's corporate governance.[127] P&G responded with the most expensive activism defense in history, sparing no expense or effort to leverage its influence.[128] Together, the activist and the company are estimated to have spent a total of $60

124. For example, our data show that hedge-fund engagements with small companies tend to have different objectives and less of a focus on governance matters, compared to larger companies. *See infra* note 266.

125. Aneliya S. Crawford, Brandon S. Gold & Daniel A. Goldstein, *Lessons Learned from Trian's Campaign at Procter & Gamble*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 25, 2018), https://corpgov.law.harvard.edu/2018/03/25/lessons-learned-from-trians-campaign-at-procter-gamble [https://perma.cc/NV9C-8YW2]; *see also* Svea Herbst-Bayliss, *Trian and P&G Highlight Activist-Corporate Collaboration After 'Fog of War,'* REUTERS (Sept. 19, 2019), https://www.reuters.com/article/us-deliveringalpha-trian-p-g/trian-and-pg-highlight-activist-corporate-collaboration-after-fog-of-war-idUSKBN1W42W8 [https://perma.cc/QGM4-9GJ3] (describing the collaborative relationship between Trian and Procter & Gamble (P&G) after the proxy contest); Manuela Pănescu & Martin Wennerström, *P&G vs. Trian Partners—The Largest Proxy Fight in History*, SUSTAINALYTICS (Oct. 11, 2017), https://www.sustainalytics.com/esg-blog/procter-gamble-trian-partners-largest-ever-proxy-fight [https://perma.cc/4SMR-8GSW] (describing Trian's strategy in the P&G proxy contest).

126. Crawford et al., *supra* note 125.

127. *Revitalize P&G Together: Vote the White Proxy Card*, TRIAN PARTNERS 78-86 (Sept. 6, 2017), https://trianpartners.com/wp-content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf [https://perma.cc/UU7F-X9FN].

128. Lauren Hirsch, *The Largest Proxy Battle Ever Is Coming to a Head on Tuesday*, CNBC (Oct. 10, 2017, 9:10 AM EDT), https://www.cnbc.com/2017/10/09/pg-proxy-battle-nelson-peltz-procter-gamble-board-decision.html [https://perma.cc/WM52-MXVZ].

million on the campaign,[129] which ultimately culminated in Trian's loss by a narrow margin.[130] Despite the bitter battle, the now-partners again made headlines a year and a half later, when Peltz and the new CEO, David Taylor, spoke publicly about their cordial communications and collaborative improvements to the company.[131]

While multimillion-dollar activist campaigns are far from an anomaly,[132] not all activist engagements unfold like this. Recently, Driver Management, a small activist investor focused on microcap banks[133] and led by former banking-industry analyst Abbott Cooper, launched a proxy campaign against First United Corporation, a commercial and consumer bank headquartered in Maryland, to elect three new independent board members.[134] As part of the campaign, Driver Management created a website—www.RenovateMyBank.com—on which they showcased a presentation they produced titled "First United: Still No Strategy."[135] But unlike Trian, Driver Management found that proxy advisors were reluctant to engage.[136] First United issued only two letters responding to Driver's

129. Pănescu & Wennerström, *supra* note 125.

130. Sharon Terlep & David Benoit, *P&G Concedes Proxy Fight, Adds Nelson Peltz to Its Board*, WALL ST. J. (Dec. 15, 2017, 7:18 PM ET), https://www.wsj.com/articles/p-g-concedes-proxy-fight-adds-nelson-peltz-to-its-board-1513377485 [https://perma.cc/PA4K-U63P].

131. Herbst-Bayliss, *supra* note 125.

132. *See, e.g.*, Liz Moyer, *Activist Hedge Funds Target Bigger and Bigger U.S. Companies in Year of the 'Super Campaign,'* CNBC (Aug. 10, 2017, 11:36 AM EDT), https://www.cnbc.com/2017/08/09/activist-hedge-funds-target-big-companies-in-year-of-super-campaign.html [https://perma.cc/R8Q4-ZSPF]; Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 103 J. FIN. ECON. 610, 611-12 (2013); *Activist Hedge Funds Often See Their Gains Wiped Out by Costs*, HARV. BUS. REV., https://hbr.org/2013/06/activist-hedge-funds-often-see [https://perma.cc/649R-XQTC].

133. The Activist Insight Podcast, *Beyond the Boardroom with Driver Management's Abbott Cooper*, ACTIVIST INSIGHT, at 03:30 (Nov. 27, 2019), https://www.buzzsprout.com/210685/2173010-beyond-the-boardroom-with-driver-management-s-abbott-cooper [https://perma.cc/4JFB-QWNL].

134. Holden Wilen, *First United Wins Proxy Fight Against Activist Investor*, BALT. BUS. J. (June 11, 2020, 3:47 PM EDT), https://www.bizjournals.com/baltimore/news/2020/06/11/first-united-wins-proxy-fight-against-investor.html [https://perma.cc/3X3C-T2KA].

135. Press Release, Driver Mgmt. Co. LLC, Driver Management Releases Statement and Presentation Regarding First United Corporation's Failure to Produce a Viable Strategic Plan (Oct. 30, 2019, 9:30 AM EDT), https://www.businesswire.com/news/home/20191030005597/en/Driver-Management-Releases-Statement-and-Presentation-Regarding-First-United-Corporation%E2%80%99s-Failure-to-Produce-a-Viable-Strategic-Plan [https://perma.cc/VLX9-MCNN].

136. Press Release, First United Corp., Glass Lewis, a Leading Independent Proxy Advisory Firm, Recommends Shareholders Vote for All of First United's Nominees (June 5, 2020, 6:00 AM ET), https://www.prnewswire.com/news-releases/glass-lewis-a-leading-independent-campaign, one that cited the mischaracterizations in Driver's claims,[137] and one that noted that Driver's proposed candidates had responded neither to information requests nor to requests for interviews.[138] Ultimately, First United engaged in settlement discussions with Driver, which rejected their offer, and First United prevailed in the proxy battle.[139]

These two activist campaigns vividly illustrate the sharp divide between corporations in the limelight and those that receive little attention from analysts, large institutional investors, or the media. The activists that engage with small companies are more likely to encounter greater difficulties in the course of their engagements, as management might be more hostile towards them, proxy advisors less supportive, soft information less available, and shareholders more dispersed and less accessible. Because such activist funds are likely to be smaller and less sophisticated, there is also a concern that their engagement will be of lower quality, thereby generating lower benefits to investors.

Finally, even if activism in smaller companies were akin to activism conducted in larger companies, the activist hedge-fund model requires meaningful accumulation of equity positions in targets,[140] which in turn limits the ability to engage with many targets simultaneously. In fact, activist hedge-fund engagements are relatively rare, accounting for 7 to 8% of public companies annually.[141] Their activity, therefore, represents more of a surgical intervention than a broad-spectrum medication.

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proxy-advisory-firm-recommends-shareholders-vote-for-all-of-first-uniteds-nominees-301071195.html [https://perma.cc/EXB2-34HS].

137. Press Release, First United Corp., First United Clarifies Driver's Misleading Statements Regarding Regulatory Actions (May 27, 2020, 7:00 AM ET), https://www.prnewswire.com/news-releases/first-united-clarifies-drivers-misleading-statements-regarding-regulatory-actions-301065917.html [https://perma.cc/G648-LEFJ].

138. Press Release, First United Sends Letter to Shareholders (Apr. 20, 2020, 8:01 ET), https://www.prnewswire.com/news-releases/first-united-sends-letter-to-shareholders-301043247.html [https://perma.cc/39Y7-8PTH].

139. Press Release, First United Issues Statement Regarding Recent Settlement Negotiations with Driver Management Company (Mar. 26, 2020, 8:00 ET), https://www.prnewswire.com/news-releases/first-united-issues-statement-regarding-recent-settlement-negotiations-with-driver-management-company-301030290.html [https://perma.cc/EMC6-BXX8]; Wilen, *supra* note 134.

140. Brav et al., *supra* note 56, at 1747 (finding that activists' median initial and maximum percentage stakes in a target are 6.3% and 9.1%, respectively).

141. *See Review and Analysis of 2020 U.S. Shareholder Activism and Activist Settlement Agreements*, SULLIVAN & CROMWELL LLP 18-19 (Dec. 2, 2020), https://www.sullcrom.com/files/upload/sc-publication-review-analysis-2020-US-shareholder-activism.pdf [https://perma.cc/2A4D-LURA]. The threat of activist intervention does lead some companies to adjust ex ante in order to prevent potential intervention by activists. Still, in many cases that focus is on preventing the engagement rather than addressing the underlying governance concerns.

d. Disclosure

The ability to initiate governance changes in public companies also depends on the level of information that is publicly available.[142] Listing rules and securities regulations, in addition to companies' charters and bylaws (also legally regulated), require companies to adopt and disclose certain governance documents. But a substantial proportion of small companies do not make these disclosures on their websites[143] or otherwise avoid mandatory disclosure.[144] Interestingly, firm size also influences the level of voluntary disclosure. Larger companies tend to disclose more governance documents and policies—as well as more information about their directors—because they are often better organized, have more resources, have larger general-counsel offices, or have more experienced board members. And, as a result, they are generally better equipped to disclose more.[145] In contrast, smaller companies disclose only what is required by law, and do not always do that.[146]

This difference in the scope of voluntary disclosure may also be attributed to the greater levels of scrutiny larger companies receive from shareholders, analysts, and the media.[147] To respond to this increased scrutiny, large companies release more information voluntarily, which enables shareholders to learn more about their governance practices and engage with those practices—and thus initiate governance changes more effectively. Small companies, in contrast, are caught in a vicious circle. With almost no effective scrutiny from large investors, they have little incentive to disclose additional information about their governance practices and board members. Without such information, large shareholders' incentives to engage with them are further reduced.

142. For a review of the purpose of disclosure and its effect on corporate governance, see, for example, Hillary A. Sale, *Disclosure's Purpose*, 107 GEO. L.J. 1045 (2019).

143. Based on data hand-collected by one of the authors, while 85% of S&P 500 companies disclosed their corporate governance guidelines, only 77% of the S&P 400 and 66% of the S&P 600 did so in 2019. For a broader discussion of nondisclosure, see Nili & Hwang, *supra* note 1, at 1107.

144. Jesse M. Fried, *Firms Gone Dark*, 76 U. CHI. L. REV. 135, 136 (2009) ("[H]undreds of small US companies—some with thousands of public shareholders—have [avoided mandatory disclosure,] while their shares continue to be publicly traded.").

145. Nili & Hwang, *supra* note 1, at 1118 (finding that these factors influence the volume of disclosure of shadow governance documents).

146. *Id.* at 1127; Fried, *supra* note 144, at 144. For additional evidence related to disclosure about board members, see Yaron Nili, *Out of Sight, Out of Mind: The Case for Improving Director Independence Disclosure*, 43 J. CORP. L. 35, 68-69 (2017).

147. *See infra* Section I.C.

e. Ownership Structure

Finally, smaller companies are also owned by a different shareholder base, which further impedes the ability of some shareholders to initiate governance changes. More specifically, smaller companies differ from large ones in two important aspects. First, small companies tend to have a higher average percentage of insider ownership compared to large companies.[148] The presence of a shareholder who can control the vote outcome reduces the chances of a successful activist campaign.[149] Moreover, since these dominant shareholders often have an effective control over the election of the company's directors, an exercise of withholding votes by public shareholders would be unlikely to apply sufficient pressure to induce controllers to adopt governance arrangements favored by other smaller public shareholders.

Second, small companies tend to have lower average institutional ownership compared with large companies,[150] and this lower representation reduces the initiation of governance changes through the submission of shareholder proposals. This is because individual investors, who submit the majority of shareholder proposals, often tailor their proposals to the voting guidelines of large institutional investors in order to achieve the support of a substantial shareholder.[151] By proposing the governance terms to which these institutional investors have publicly committed, individual investors translate universal governance guidelines into company-specific governance changes.[152] However, with a lower percentage of institutional ownership and a higher percentage of retail investors who tend not to participate in the voting process,[153] shareholder proposals are less likely to pass (or even be submitted in the first place).

148. *See infra* Section II.C. Among other things, we show that the average insider-ownership percentage for the last twenty years was 32% for the Bottom 200 compared to 5% for the S&P 500. *See also* Papadopoulos, *supra* note 90 ("According to ISS data, controlled companies make up only 3.6 percent of S&P 500 and 8.4 percent of the entire Russell 3000.").

149. *See* Kobi Kastiel, *Against All Odds: Hedge Fund Activism in Controlled Companies*, 2016 COLUM. BUS. L. REV. 60, 65 (arguing that when activism is conducted against majority-controlled companies, the likelihood of success decreases significantly).

150. *See infra* Section II.C.

151. Bebchuk & Hirst, *supra* note 103, at 2088-91. Gadflies support their proposals with reference to guidelines of large institutional investors and industry best practices. *See* Asaf Eckstein, The Rise of Corporate Guidelines 5-6 (Aug. 2, 2021) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3705140 [https://perma.cc/J7TF-PNP3].

152. Kastiel & Nili, *supra* note 50, at 574-76.

153. *See, e.g.*, Kastiel & Nili, *supra* note 123, at 60-69; Fisch, *supra* note 123, at 14-16.

C. *The Ineffectiveness of Alternative Disciplinary Forces*

As we explained in the previous Section, institutional investors and certain activist shareholders have limited incentives, resources, and tools to engage with and initiate governance changes in the large swath of smaller publicly traded corporations in the United States. To add insult to injury, other important disciplinary forces that help curb managerial entrenchment in large corporations (such as analyst and media coverage, as well as public and private enforcement) are ineffective in small firms. While from the perspective of analysts, media reporters, and private and public enforcers, it may be completely rational to focus on large targets, the cumulative effect of this approach is alarming: a sizable portion of publicly traded companies are immune from the traditional disciplinary mechanisms that scholars, courts, and regulators have touted as important pillars of our governance system.

1. *Analyst Coverage*

Analysts are one of the main sources of information available to investors with respect to securities investment. They analyze voluminous information on public companies, predict key performance measures, and provide summary recommendations to investors. Previous research has already shown that analysts have significant influence on investor behavior.[154] Thus, it is not surprising that managers perceive analysts as one of the most important factors affecting the share price of their corporation.[155]

In addition to their contribution to investors' decisions, financial analysts also play an important role in corporate governance as external monitors of managers.[156] They track financial statements regularly, interact directly with managers, and distribute public and private information to investors about the quality of firm policies through research reports. By making stock prices more informative, analyst coverage disciplines underperforming managers and serves as an

154. Stephen J. Choi, *The Problems with Analysts*, 59 ALA. L. REV. 161, 167-70 (2007).

155. John R. Graham, Campbell R. Harvey & Shiva Rajgopal, *The Economic Implications of Corporate Financial Reporting*, 40 J. ACCT. & ECON. 3, 24 (2005).

156. Kee H. Chung & Hoje Jo, *The Impact of Security Analysts' Monitoring and Marketing Functions on the Market Value of Firms*, 31 J. FIN. & QUANTITATIVE ANALYSIS 493, 493-97, 511 (1996); Tao Chen, Jarrad Harford & Chen Lin, *Do Analysts Matter for Governance? Evidence from Natural Experiments*, 115 J. FIN. ECON. 383, 383-84, 406-07 (2015).

important incentive device for improving management behavior.[157] It is therefore hard to overstate the positive effect that analyst coverage has for firms as an external-governance gatekeeping mechanism.[158]

However, the effectiveness of analysts' coverage as a disciplinary force is not identical in all publicly traded companies. There are a few parameters that affect analysts' selection bias in favor of large firms. First, large firms stimulate the interest of a greater number of investors and are likely to generate more share transactions, which in turn increases the aggregate demand for analysts' services.[159] Second, the aggregate demand for analysts' services decreases with firm size because investors are likely to generate lower profits from pertinent information on smaller firms.[160] Finally, analysts are inclined to cover firms with better information environments,[161] and large firms tend to benefit from significant information advantages.[162]

A rich body of empirical evidence supports this analysis, clearly showing that large firms enjoy wider and closer analyst coverage than small firms. For example, an early study examining the factors that lead to differences in analyst cov-

157. Financial analysts are known to affect corporate policy decisions. *See* Fang (Frank) Yu, *Analyst Coverage and Earnings Management*, 88 J. FIN. ECON. 245, 254-66 (2008) (finding that firms followed by more analysts manage their earnings less); Xin Chang, Sudipto Dasgupta & Gilles Hilary, *Analyst Coverage and Financing Decisions*, 61 J. FIN. 3009, 3027-30, 3037 (2006) (finding that firms with less analyst coverage issue equity less frequently but in larger amounts); François Derrien & Ambrus Kecskés, *The Real Effects of Financial Shocks: Evidence from Exogenous Changes in Analyst Coverage*, 68 J. FIN. 1407, 1424-28 (2013) (finding that firms that lose an analyst decrease their investment and financing compared to firms that do not).

158. However, analyst coverage is not necessarily required in every firm. For instance, small firms that trade in an extremely illiquid market with only one transaction every month do not warrant the expenditure of resources in providing analyst research distributed out to the public marketplace. Choi, *supra* note 154, at 204.

159. Ravi Bhushan, *Firm Characteristics and Analyst Following*, 11 J. ACCT. & ECON. 255, 261-62, 270-71 (1989).

160. *Id.*; *see also* D. Shores, *The Association Between Interim Information and Security Returns Surrounding Earnings Announcements*, 28 J. ACCT. RSCH. 164, 167 (1990) ("Financial analysts and the financial press may concentrate more heavily on larger firms because . . . information about larger firms may be of interest to more investors than information about smaller firms.").

161. *See, e.g.*, Mark H. Lang & Russell J. Lundholm, *Corporate Disclosure Policy and Analyst Behavior*, 71 ACCT. REV. 467, 482-84 (1996) (finding that firms with more informative disclosure policies attract a larger analyst following); Jennifer Francis, J. Douglas Hanna & Donna R. Philbrick, *Management Communications with Securities Analysts*, 24 J. ACCT. & ECON. 363, 377-81 (1997) (finding that corporate presentations benefit firms by increasing analyst coverage).

162. *See* Bhushan, *supra* note 159, at 261-62; Robert N. Freeman, *The Association Between Accounting Earnings and Security Returns for Large and Small Firms*, 9 J. ACCT. & ECON. 195, 198-99 (1987).

erage found firm size to be a significant variable affecting the extent of such coverage.[163] Similarly, another study concluded that analysts' recommendations skewed toward large-capitalization, well-followed companies, showing that only 1% of the collected analyst recommendations in its dataset were for companies in the two smallest market-capitalization deciles.[164] An additional study examining the determinants of the number of analysts following a firm confirmed the findings of prior studies on analyst selection, finding that analysts are more likely to cover a firm that is increasing in size, is a member of the S&P 500 index, has experienced an increase in trading volume, or has issued debt or equity in close proximity to the analyst's inspection.[165] A host of other studies similarly indicated that small firms are subject to less coverage than mid- and large-cap firms.[166]

2. *Media Coverage*

Along with analyst coverage, media coverage is another essential disciplining force on the firm's management and corporate governance mechanisms. In their pioneering article, I.J. Alexander Dyck and Luigi Zingales identified that the role of the media in disciplining underperforming managers involves emphasizing both business heroes and villains.[167] Media has become a powerful mechanism that builds and destroys reputations.[168] Executives, for example, wish to be associated in the mass media with successful performance, which enhances their

163. Bhushan, *supra* note 159, at 270-71.

164. Kent L. Womack, *Do Brokerage Analysts' Recommendations Have Investment Value?*, 51 J. FIN. 137, 141, 143 (1996). Another study found that analyst coverage is positively related to firm size, growth, trading volume of the firm's shares, and whether the firm accesses public debt and equity markets. It also found that analyst coverage is significantly greater for firms with larger research and development and advertising expenses relative to their industry. *See* Mary E. Barth, Ron Kasznik & Maureen F. McNichols, *Analyst Coverage and Intangible Assets*, 39 J. ACCT. RSCH. 1, 17-21 (2001).

165. Lihong Liang, Edward J. Riedl & Ramgopal Venkataraman, *The Determinants of Analyst-Firm Pairings*, 27 J. ACCT. PUB. POL'Y 277, 285-88 (2008).

166. For additional studies regarding the influence of firm size over analyst coverage, see Choi, *supra* note 154, at 170; Brad Barber, Reuven Lehavy, Maureen McNichols & Brett Trueman, *Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns*, 56 J. FIN. 531, 531-34 (2001); and Roni Michaely & Kent L. Womack, *Conflict of Interest and the Credibility of Underwriter Analyst Recommendations*, 12 REV. FIN. STUD. 653, 656-57 (1999).

167. I.J. Alexander Dyck & Luigi Zingales, *The Corporate Governance Role of the Media* 21 (Ctr. for Rsch. Sec. Prices, Working Paper No. 543, 2002), https://ssrn.com/abstract=335602 [https://perma.cc/3K4X-NSUH].

168. *Id.*

professional and social status. Furthermore, as Roy Shapira suggests, media coverage in earlier stages of litigation proceedings can have just as significant of a role in disciplining managers and influencing public opinion as the outcomes of litigation.[169]

In contrast, media coverage does not function as a powerful disciplining tool when it comes to small firms. The media targets firms based on their visibility and corporate governance weaknesses.[170] Indeed, a rational reporter will choose to publish articles that maximize exposure to her articles at a minimal cost. Hence, the reporter will focus on large firms that are more visible, as information about them is more available.[171] Intuitively, larger firms are better known and more accessible to the public; as a result, governance in small firms is simply not headline material.[172]

This intuition is confirmed by empirical research. A survey analyzing corporate news coverage between 2001 and 2012 found that firm size was an essential determinant of media coverage, concluding that larger firms generally received more coverage than smaller firms.[173] These studies suggest that the media is structurally biased toward covering large firms.

3. *Public Enforcement*

Public enforcement is also a critical disciplining mechanism.[174] This type of enforcement is significantly more crucial to small firms, as these firms are associated with a high incidence of fraud.[175] They are also less likely to be targeted

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169. *See* Roy Shapira, *A Reputational Theory of Corporate Law*, 26 STAN. L. & POL'Y REV. 1, 58 (2015).

170. *Id.* at 9-10; *see also* Kenneth B. Davis, Jr., *The Forgotten Derivative Suit*, 61 VAND. L. REV. 387, 418, 450 (2008) ("Misconduct at smaller companies, whose shares are traded less actively, will be more likely to escape the awareness and the interest of governmental agencies and the media.").

171. Gregory S. Miller, *The Press as a Watchdog for Accounting Fraud*, 44 J. ACCT. RSCH. 1001, 1009 (2006).

172. Dennis M. Garvis, *Does Firm Size Matter in Corporate Governance? An Exploratory Examination of Bebchuk's Entrenchment Index*, 7 COMPETITION F. 188, 190 (2009).

173. Lili Dai, Jerry T. Parwada & Bohui Zhang, *The Governance Effect of the Media's News Dissemination Role: Evidence from Insider Trading*, 53 J. ACCT. RSCH. 331, 338-43 (2015); *see also* Miller, *supra* note 171, at 1025-30 (finding that the press acts as a monitor for accounting fraud by rebroadcasting information and undertaking original analysis).

174. *See* James D. Cox, Randall S. Thomas & Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 DUKE L.J. 737, 777-79 (2003); Howell E. Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence*, 93 J. FIN. ECON. 207, 209-10, 237-38 (2009).

175. *See* sources cited *infra* note 72.

by private parties due to, among other factors, the smaller compensation achievable in lawsuits filed against these firms.[176]

However, regulators might engage in a lower level of enforcement activities against small firms. Since regulators operate in an environment of limited resources, they cannot ensure maximal compliance and instead must pick and choose their targets.[177] A rational, value-maximizing regulator will engage in enforcement activities only when enforcement costs do not exceed enforcement benefits.[178] As noted above, small firms are less visible, making information about their conduct less available.[179] Regulators are also not immune to considering the press reaction and level of media coverage that their cases will receive when selecting their targets.[180] With the media biased toward covering large firms,[181] regulators are encouraged to focus on these firms, which are more likely to be the subject of news headlines, thereby providing the regulators with more exposure. Another determinant of whether a firm will be investigated is the size of compensation expected from enforcement, which also varies based on firm size.[182] For these reasons, enforcement against small noncompliant actors is costly and has a milder deterrent effect, and regulators consider small-company regulation to be inefficient.[183]

Empirical evidence supports the proposition that regulators disproportionally allocate their resources to larger firms. For example, one study found that "the probability of being subject to an [Occupational Safety and Health Administration] inspection varies from 100% for the largest firms to 0.002% for the smallest firms, with a powerful correlation between probability of inspection and firm size at every point on the spectrum of firm sizes."[184] Similarly, Brian J. Bushee and Christian Leuz studied obedience to Securities and Exchange Commission (SEC) disclosure regulations and found that noncompliant firms tend

176. Cox et al., *supra* note 174, at 777-79.

177. Richard J. Pierce, Jr., *Small Is Not Beautiful: The Case Against Special Regulatory Treatment of Small Firms*, 50 ADMIN. L. REV. 537, 561-62 (1998).

178. Kellen Zale, *When Everything Is Small: The Regulatory Challenge of Scale in the Sharing Economy*, 53 SAN DIEGO L. REV. 949, 964-65 (2016).

179. *See supra* notes 171-172 and accompanying text.

180. Rebecca Files, *SEC Enforcement: Does Forthright Disclosure and Cooperation Really Matter?*, 53 J. ACCT. & ECON. 353, 371 (2012).

181. *See supra* Section I.C.2.

182. Deniz Anginer, M.P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *Should Size Matter When Regulating Firms? Implications from Backdating of Executive Options*, 15 N.Y.U. J. LEGIS. & PUB. POL'Y 1, 37-38 (2012).

183. *See, e.g.*, Zale, *supra* note 178, at 964-65.

184. Pierce, *supra* note 177, at 561-62.

to be smaller.[185] Empirical research concerning fraudulent behavior has also found that those companies committing financial fraud are relatively small ones.[186]

4. *Private Enforcement*

Another important mechanism that disciplines managerial behavior is private enforcement, including shareholder lawsuits. The private-enforcement right, through derivative or class-action litigation, enables individual shareholders to hold managers accountable for misbehavior, thus reducing agency costs.[187] However, the ability to bring a lawsuit depends on laws that determine the ease with which shareholders can bring these suits.[188]

Evidence shows that small firms tend to incorporate in jurisdictions like Nevada in order to limit the ability of shareholders to bring private-enforcement suits.[189] For example, Michal Barzuza and David C. Smith have found that "[t]he market value of assets of the median-sized firm in Nevada is about $24 million . . . compared with median asset values of $290 million for Delaware firms and $171 million for firms in other states."[190] Under Nevada law, directors are mandatorily held liable only for acts that both violate the duty of loyalty and involve "intentional misconduct, fraud, or a knowing violation of the law."[191] Hence, in Nevada, the default option is no liability for breaches of loyalty and

185. Brian J. Bushee & Christian Leuz, *Economic Consequences of SEC Disclosure Regulation: Evidence from the OTC Bulletin Board*, 39 J. ACCT. & ECON. 233, 235, 261 (2005).

186. Mark S. Beasley, Joseph V. Carcello & Dana R. Hermanson, *Fraudulent Financial Reporting: 1987-1997: An Analysis of U.S. Public Companies*, COMM. SPONSORING ORGS. TREADWAY COMM'N 2 (1999), https://egrove.olemiss.edu/cgi/viewcontent.cgi?article=1330&context=aicpa_assoc [https://perma.cc/2P2F-MRFH].

187. John Armour, Bernard S. Black, Brian R. Cheffins & Richard T. Nolan, *Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States*, 6 J. EMPIRICAL LEGAL STUD. 687, 691 (2009).

188. *See, e.g.*, *id.* at 692-96.

189. Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165, 1178 (2012); Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. FIN. STUD. 3593, 3606-07 (2014).

190. Barzuza & Smith, *supra* note 189, at 3607. *But see* Ofer Eldar, *Can Lax Corporate Law Increase Shareholder Value? Evidence from Nevada*, 61 J. L. ECON. 555 (2018) (providing evidence that Nevada's lax corporate law does not harm shareholder value for firms that self-select into Nevada).

191. NEV. REV. STAT. § 78.138 (2019); *see* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 935, 941 (2012).

care duties, and the company can opt out of the default arrangement only with managerial approval.[192]

There is another important explanation as to why private enforcement does not work optimally in small firms. Fee awards in derivative and class-action lawsuits tend to be a function of the recovery amount.[193] When planning to file a derivative suit, economically rational lawyers want to maximize the expected fee award.[194] As a result, they are less likely to sue small firms, as the expected recovery in those situations is lower.[195]

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Before moving on to Part II, it is also important to emphasize that each of the disciplinary forces presented in this Section does not operate in isolation. Rather, there are mutual interactions among them. For example, one could expect that wider and closer analyst coverage would increase the information available on a specific company, which in turn would increase the likelihood that public or private actors would engage in enforcement activity against the company. Similarly, a shareholder lawsuit increases the level of information disclosed about a given company (for example, through early-stage disclosure of information), which then increases media coverage and reputational sanctions.[196] The lack of disciplinary forces likely has an even broader cumulative effect once we account for these synergies.

II. THE CORPORATE GOVERNANCE GAP

Researchers in the fields of law and finance have long focused on corporate governance metrics. Beginning in the late 1990s, academics from both fields have attempted to move beyond theoretical inquiries by taxonomizing, measuring, and quantifying corporate governance arrangements.[197] These emerging fields of empirical corporate governance studies have fostered the creation of commercial databases offering insights into corporate governance policies. They

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192. Barzuza, *supra* note 191, at 949-52.

193. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1543 (2006).

194. *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 700-01 (1986).

195. *See* Coffee, *supra* note 193, at 1543.

196. *See* Shapira, *supra* note 169, at 21.

197. *See, e.g.*, Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467, 467 (2010); Gompers et al., *supra* note 5, at 107; Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783, 783 (2009).

have also prompted the creation of several widely used corporate governance ratings systems to label companies and practices as "good" or "bad" and to predict firm performance based on these metrics.[198] These datasets and ranking systems have skyrocketed in popularity among academics and have pushed corporate governance further into the limelight.[199]

Despite the voluminous literature in the field and significant use of governance indexes, the governance of small public firms has not been extensively examined in the past.[200] This Part aims to fill this literature gap. Section II.A examines and contrasts key governance provisions in small firms, as well as their board structure, with those of large companies. Section II.B then examines the different channels of activists' engagements with small firms, contrasted with large firms. Section II.C examines institutional investors' engagements with small firms, as well as their ownership structure—again, contrasted with large firms. Finally, Section II.D explains why the gap we identify is not merely due to the unique attributes of small firms. Altogether, this Part provides a rich account of the corporate governance of small firms and involves one of the most comprehensive datasets to examine corporate governance in small and mid-size companies. The data are unequivocal: smaller companies do not adopt the corporate governance metrics that are common among large firms. And even when they do, there is very little transparency regarding the metrics they have adopted.

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198. The most widely used among them is the governance index. *See* Gompers et al., *supra* note 5, at 107; *see also* Bernard Black, Antonio Gledson de Carvalho, Vikramaditya Khanna, Woochan Kim & Burcin Yurtoglu, *Corporate Governance Indices and Construct Validity*, 25 CORP. GOVERNANCE INT'L REV. 397, 398 (2017) (providing a comparative review of several major indices).

199. For example, the paper in which a widely used governance index was initially proposed, *see* Gompers et al., *supra* note 5, has been downloaded over 30,000 times on SSRN, Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, SSRN, https://ssrn.com/abstract=278920 [https://perma.cc/9ALB-UCL4].

200. The last couple of years reflect a welcome sign of more attention to the topic by some practitioners. *See, e.g.*, Julie Daum, Laurel McCarthy, Ann Yerger & Spencer Stuart, *Spencer Stuart S&P MidCap 400 Board Report*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 12, 2021), https://corpgov.law.harvard.edu/2021/02/12/spencer-stuart-sp-midcap-400-board-report [https://perma.cc/RMK5-ZHWX]; Kosmas Papadopoulos, Robert Kalb, Angelica Valderrama & Jared Sorhaindo, *U.S. Board Study: Board Accountability Practices Review*, ISS 4-5 (Apr. 17, 2018), https://www.issgovernance.com/file/publications/board-accountability-practices-review-2018.pdf [https://perma.cc/E2R9-HY2Z].

A. Data on Governance Practices

1. Methodology

This Section utilizes a comprehensive dataset collected from a number of sources to analyze how governance metrics vary for companies of different market capitalizations. We collected data from the last fifteen years—from 2005 through 2020—for companies that make up the S&P 500, S&P 400, S&P 600, and the bottom 200 companies of the Russell 3000 for each year (we refer to these latter companies as the "Bottom 200"). Where available, we also included historical data for the last twenty years: from 2000 through 2020.

We first obtained all variables of interest for the aforementioned indexes, including information on certain key governance metrics, details about boards of directors, and various voting requirements. To understand how these metrics have changed over the last twenty years, we also obtained the same data for the historical listings of the S&P 600, S&P 500, S&P 400, and the Bottom 200. We compiled the historical data from 2005 to 2020 for variables such as classified boards, majority voting to elect directors, a supermajority requirement to amend governance documents, action by written consent, proxy access, board tenure, board independence, director gender and age, and other board-related metrics. For historical governance and director data, we used the legacy RiskMetrics and the ISS databases within the Wharton Research Data Services (WRDS) and supplemented them with board-related information from Equilar's BoardEdge dataset.[201] To further analyze the disparities between companies of different sizes, we obtained the market capitalization for all companies within the S&P 1500 for each year from WRDS's Center for Research in Security Prices. We then divided the companies into equal deciles for each year to analyze these metrics across various market capitalizations. As the Russell 3000 is not covered by the aforementioned datasets, the data on classified boards, board independence, percentage of female board members, and proxy access for the Bottom 200 companies were manually collected and hand coded from each company's proxy statements, other filings, and investor-relations website. Therefore, these data were only collected in five-year intervals (for the years 2005, 2010, 2015, and 2020). All variables were calculated based on an average of each index for each year and then on an average for each company within that respective index.

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201. We obtained data from 2000 to 2006 from the legacy RiskMetrics database and data from 2007 to 2019 from the ISS database.

2. *Shareholder Rights and Entrenchment Devices*

This Section surveys the prevalence of major governance provisions in small firms over the past twenty years and contrasts them with those of large firms. First, we document an overall decline over the past twenty years in the use of governance provisions that entrench insiders and an overall increase in the use of governance provisions that enhance shareholder voting power. This trend can be explained by the rise of shareholder activism and public firms' increased attention to governance provisions.[202]

Second, and most interestingly, this trend has not developed uniformly among publicly traded firms. When it comes to shareholder rights, size matters. The movement away from governance provisions that entrench insiders and the empowerment of shareholder voting rights have been much more significant among large-cap companies than among small-cap ones. And even within the category of small firms, we find meaningful differences between firms at the bottom of the S&P 1500 and those at the bottom of the Russell 3000, with the latter granting fewer protections to public investors.

Third, we find that the differences are not only a function of the size of the firm, but are also concentrated among specific governance provisions: namely, some of the most egregious entrenchment mechanisms. Indeed, the gap is particularly significant when it comes to certain provisions that investors strongly oppose, such as classified boards, majority voting for director elections, and supermajority provisions to amend corporate charters. While investors exert efforts to eliminate those provisions in large-cap companies, they do not exercise similar efforts in the smaller ones. The result is a clear divide in the corporate governance landscape.

a. *Classified Boards*

We begin our analysis with a well-known takeover defense: a classified board. When a board is classified, directors are organized into equally divided classes of directors, usually two or three, and each class of directors faces election every two or three years.[203] A company can create a classified board through its charter or bylaws.[204] A classified board decreases the risk of a hostile takeover by ensuring that a potential acquirer cannot simply replace an entire board at

202. *See supra* Section I.A.

203. John C. Coates IV, *Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?*, 54 U. MIA. L. REV. 783, 783 (2000).

204. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 894 (2002).

once.[205] When combined with a poison pill, this protection becomes extremely effective, forcing a potential acquirer to conduct a successful proxy contest at the company's annual shareholder meeting for two consecutive years before it can take over the board and revoke the pill.[206] In fact, there has never been a hostile acquisition of a firm with an effective staggered board where the firm kept its pill in place.[207]

The merits of staggered boards have been the subject of vigorous academic debate.[208] Many argue that having directors stand for elections annually makes them more accountable to shareholders.[209] By requiring directors to focus on the interests of shareholders, annual elections could thereby improve firm performance and market value.[210] In contrast, some have lauded the ability of staggered boards to allow companies to focus on long-term performance.[211]

While the academic debate may be ongoing, in practice, investors have already made up their minds. There is clear and widespread support for annual elections among institutional investors, as it enables shareholders to register their views on the performance of all directors at each annual meeting.[212] Prominent mutual funds, such as BlackRock, State Street, Vanguard, Fidelity, and T. Rowe Price, which collectively cast a significant fraction of the votes at large U.S.

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205. *Id.*

206. *Id.* at 912-13.

207. *Id.* at 914.

208. For a review of the empirical evidence, see Lucian Bebchuk, Scott Hirst & June Rhee, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157 (2013).

209. *United States: Proxy Voting Guidelines Benchmark Policy Recommendations*, ISS 13-14, 18 (Nov. 19, 2020), https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf [https://perma.cc/U5NR-V4DZ] (explaining that classified boards are a problematic structure that should be voted against); Grant Bremer, *Declassified Boards Are More Likely to Be Diverse*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 15, 2017), https://corpgov.law.harvard.edu/2017/08/15/declassified-boards-are-more-likely-to-be-diverse [https://perma.cc/G598-6R29] (highlighting advocates' claim that declassified boards increase accountability).

210. Bebchuk et al., *supra* note 208, at 162-63.

211. *See, e.g.*, K.J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422, 422-23 (2017) (finding a positive association between staggered boards and long-term firm value).

212. *See infra* note 214.

companies,[213] all have voting guidelines and policies that support annual elections of all directors, and all are in favor of board-declassification proposals.[214] The significant shareholder support for declassification proposals is consistent with empirical studies reporting that classified boards are associated with lower firm value and inferior outcomes for shareholders.[215] The evidence also indicates that classified boards could have certain undesirable effects on managerial decision-making and could harm shareholders if boards use this defense to entrench themselves.[216]

Not surprisingly, investors' widespread support of annual elections has led to a significant upward trend in the number of public companies that have declassified their boards and moved to annual elections over the past two decades. This shift is largely the result of shareholder proposals requesting that large S&P

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213. *See, e.g.*, Bebchuk & Hirst, *supra* note 48, at 727-41 (showing that the big three index-fund managers—BlackRock, Vanguard, and State Street Global Advisors—collectively cast an average of about 25% of the votes at S&P 500 companies); *see also* Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 B.U. L. REV. 1459, 1508-09 (2019) (highlighting the increased holdings of institutional investors).

214. *See Proxy Voting Guidelines for U.S. Securities*, BLACKROCK 7 (Jan. 2021), https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf [https://perma.cc/94GQ-KHAJ]; *North America Proxy Voting and Engagement Guidelines*, STATE ST. GLOB. ADVISORS 6 (Mar. 2021), https://www.ssga.com/library-content/pdfs/ic/proxy-voting-and-engagement-guidelines-us-canada.pdf [https://perma.cc/FWD5-LNV5]; *Summary of the Proxy Voting Policy for U.S. Portfolio Companies*, VANGUARD 16 (Apr. 2020), https://about.vanguard.com/investment-stewardship/portfolio-company-resources/2020_proxy_voting_summary.pdf [https://perma.cc/KX4N-WBYF].

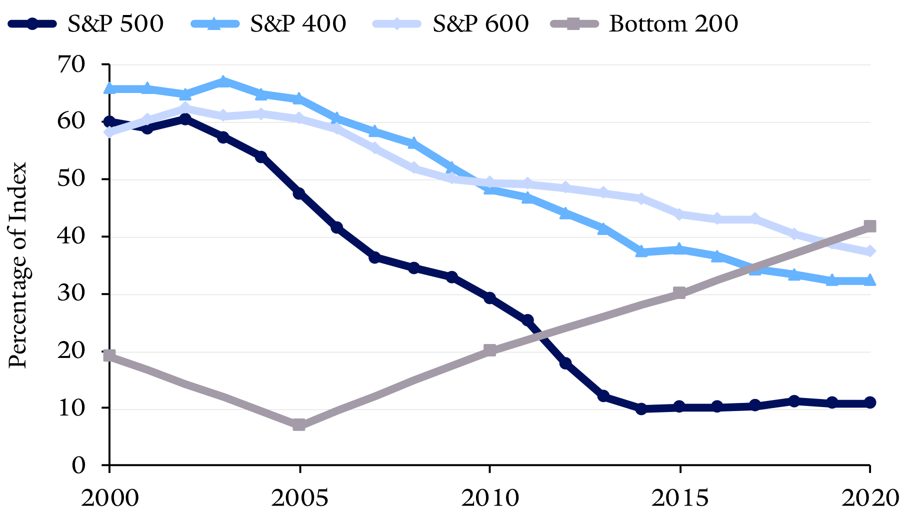
215. For a review of this evidence, see Bebchuk et al., *supra* note 208, at 164-65. *See also* Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment*, 110 J. FIN. ECON. 627, 628 (2013) (finding that classified boards bring about, not merely reflect, reduced shareholder value).

216. *See* Bebchuk et al., *supra* note 208, at 165. Some studies have challenged the empirical evidence that firm value is negatively affected by classified boards. *See, e.g.*, Cremers et al., *supra* note 211, at 422-24. However, the methodology of the Cremers, Litov, and Sepe study has been criticized by other scholars. *See, e.g.*, Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Is the Staggered Board Debate Really Settled?: A Coda*, 168 U. PA. L. REV. ONLINE 113, 114 (2020); Lucian Bebchuk & Alma Cohen, *Recent Board Declassifications: A Response to Cremers and Sepe*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 23, 2017), https://corpgov.law.harvard.edu/2017/05/23/recent-board-declassifications-a-response-to-cremers-and-sepe [https://perma.cc/F27W-XNEC]; *see also* Emiliano Catan & Michael D. Klausner, Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Value? (2017) (unpublished manuscript), https://gcgc.global/wp-content/uploads/2018/05/7. -Catan_Board_Destaggerings_-_Draft_-_8-27-2017.pdf [https://perma.cc/N6YV-94VV] (finding that there is no evidence that destaggering a board reduces the value of high-research and development firms).

500 companies declassify their board structure.[217] Interestingly, this trend has not developed uniformly among all firms, with the movement away from staggered boards being much more significant within large-cap companies compared with small-cap companies.

Figure 1 below clearly illustrates how this disparity between large companies and smaller ones has become more pronounced over time. For example, in 2000, about 60% of companies both in the largest index, the S&P 500, and a smaller one, the S&P 600, had a classified board. However, in 2020, only 11% of the larger companies within the S&P 500, compared with 37% of smaller companies within the S&P 600, had a classified board. The percentage of firms with a classified board in the S&P 600 is therefore almost four times higher. Companies outside of the S&P 1500 are even more likely to have a classified board, with 42% of the Bottom 200 having one in 2020. Notably, despite the overall decline in classified boards in the S&P 1500, they have become *more* popular within the Bottom 200 over the last fifteen years. These data show that firms that receive less attention from investors are more likely to take advantage of this lack of oversight to adopt governance provisions that investors generally oppose.

FIGURE 1. TRENDS IN THE USE OF CLASSIFIED BOARDS OVER TIME



217. For example, in 2012, the Shareholder Rights Project at Harvard Law School assisted institutional investors in using shareholder proposals to precipitate the declassification of previously staggered boards at roughly 100 S&P 500 and Fortune 500 companies. *See* Bebchuk et al., *supra* note 208.

b. *Majority Voting for Director Election*

Under the standard of majority voting, any board candidate in an uncontested election is required to obtain a majority of the votes before being seated, in contrast to the historically common plurality standard.[218] Proponents of shareholder democracy have long favored a standard requiring majority voting, arguing that it "ensures that shareowners' votes count and makes directors more accountable to the shareowners they represent."[219] Not surprisingly, over the last two decades, there has been a significant move from plurality to majority voting for corporate directors, largely the result of shareholder campaigns.[220]

Here, again, we find that voting standards for director elections differ greatly depending on the size of the company. Although increasing in popularity, a majority-voting standard still remains less prevalent among small-cap companies. For example, as shown in Figure 2 below, 88% of companies that make up the S&P 500 required a majority vote for board elections in 2020, but only 55% of the S&P 600 and 29% of the Bottom 200 required such a vote.[221] Moreover, while we can observe a clear movement toward majority voting in all S&P indexes during the past ten years, the gap between large and small companies persists.

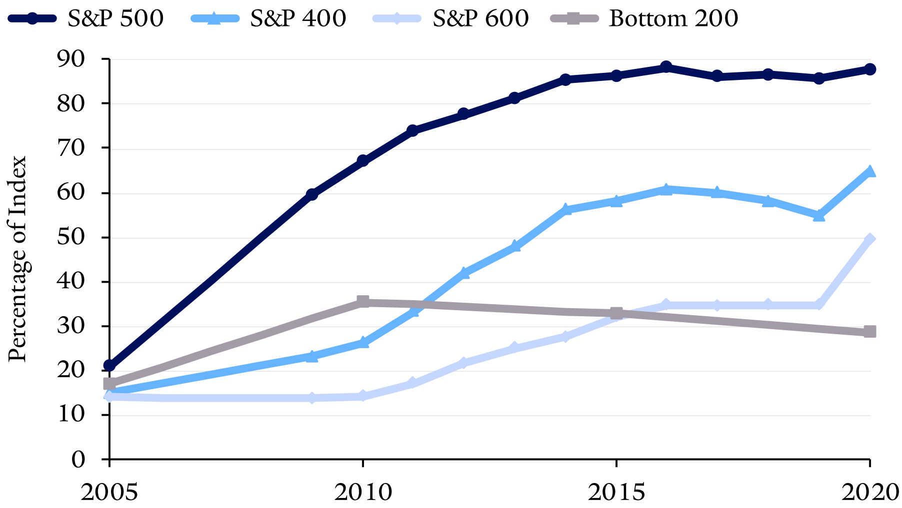
218. When directors are elected by a plurality of the votes cast, in uncontested elections, a candidate who receives even a single vote is elected. *See, e.g.*, DEL. CODE ANN. tit. 8, § 216 (2021); Choi et al., *supra* note 85, at 1119.

219. *See, e.g.*, *Majority Voting for Directors*, COUNCIL OF INSTITUTIONAL INVS. (2021), https://www.cii.org/majority_voting_directors [https://perma.cc/5MNV-P9JE].

220. *See, e.g.*, DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON 75 (2018) (discussing how the United Brotherhood of Carpenters Fund utilized shareholder proposals to successfully influence many target companies to adopt majority voting in shareholder elections).

221. Ten years ago, 67% of the S&P 500 required a majority vote, compared to 14% of the S&P 600.

FIGURE 2. TRENDS IN MAJORITY VOTING



c. Supermajority Requirements to Amend the Charter

Supermajority provisions limit the extent to which a majority of shareholders can impose its will on management. In the past, shareholders have registered strong opposition to such provisions since they make it more difficult for shareholders to have a say on important governance decisions.[222] Supermajority requirements also provide a second line of defense against a takeover. When such provisions are present, insiders holding a block of shares might be in a veto position to defeat or frustrate the plans of the hostile acquirer to amend the charter or to consummate a merger.[223]

Despite shareholders' general opposition to supermajority requirements, we find that the prevalence of these provisions varies widely depending on market capitalization. In particular, smaller companies are much more likely to have a supermajority requirement in place. For example, in 2020, only 35% of companies within the S&P 500 had a supermajority requirement, compared with 50%, 52%, and 56% of the S&P 400, S&P 600, and Bottom 200, respectively.[224]

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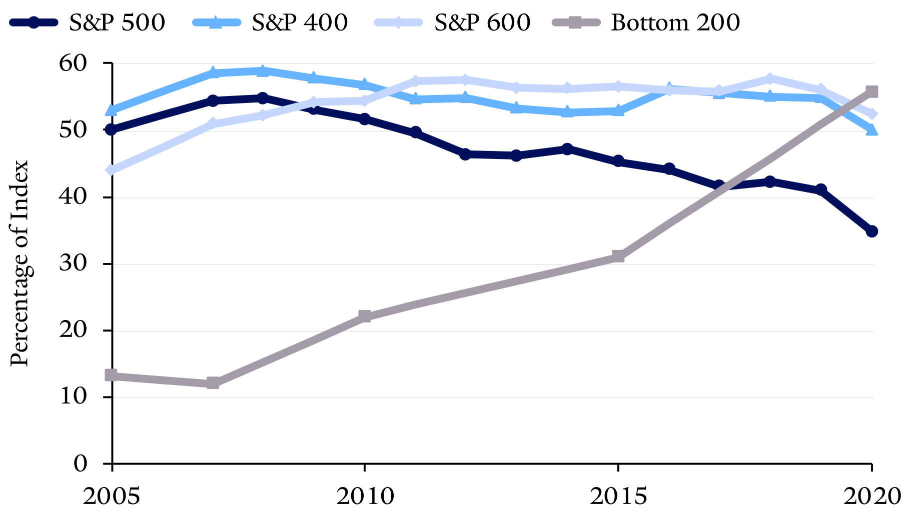
222. Bebchuk et al., *supra* note 197, at 789-92.

223. *Id.* at 792.

224. There are some governance metrics that do not vary based on the size of the company. For example, 96% of all companies, regardless of index, have bylaws that can be made by or at the direction of the board.

Moreover, compared with smaller companies, larger companies have had a more significant decline in the presence of supermajority provisions. The companies in the S&P 500 had a 25% decline from 2005 to 2020 in supermajority requirements to amend the charter, compared with a 6% decline for the S&P 400 and a slight increase in the S&P 600.[225]

FIGURE 3. TRENDS IN THE SUPERMAJORITY REQUIREMENT TO AMEND CHARTERS



d. Shareholders' Right to Call Special Meetings

At special meetings, shareholders who are unhappy with the composition of the board may be able to elect new directors or take other action without having to wait until the annual meeting.[226] In the past ten years, the right to call special meetings has become one of the most popular shareholder proposal topics, and companies have increasingly accepted these requests.[227] While scholars have argued that the practical significance of this right is limited,[228] what matters for

225. This finding is even more pronounced for the top 10% of public companies in terms of market capitalization, which experienced a 50% decline from 2007 to 2019 in supermajority requirements.

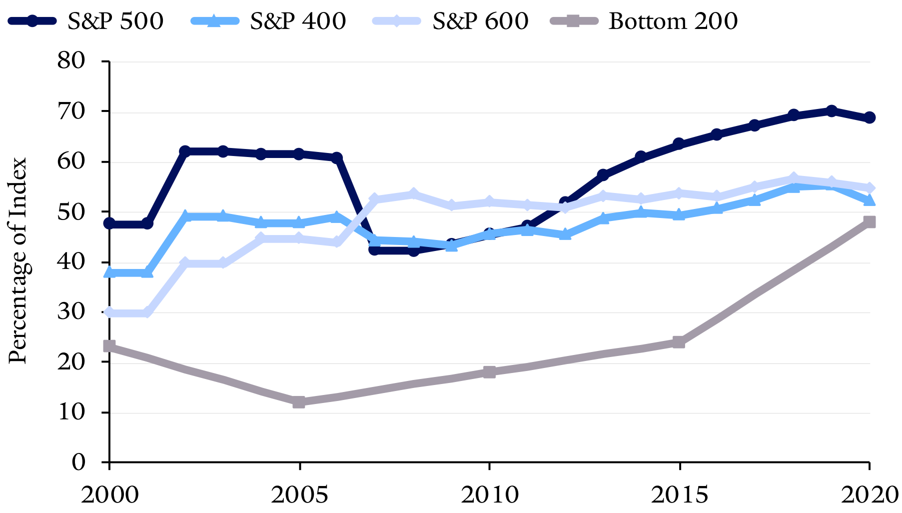
226. Emiliano M. Catan & Marcel Kahan, *The Never-Ending Quest for Shareholder Rights: Special Meetings and Written Consent*, 99 B.U. L. REV. 743, 746 (2019).

227. *Id.*

228. *Id.* at 756-58.

our purpose is how the presence of this provision allowing for shareholders to call a special meeting, which is strongly supported by shareholders, is distributed among public companies. Once again, we find that larger companies are more likely to allow shareholders to hold special meetings compared with small-cap companies. In 2020, 69% of the S&P 500 allowed for special meetings, compared with 52%, 55%, and 48% of the S&P 400, S&P 600, and Bottom 200, respectively.

FIGURE 4. TRENDS IN SHAREHOLDERS' RIGHTS TO CALL SPECIAL MEETINGS OVER TIME



e. Proxy Access

Proxy access provides public shareholders with the ability to nominate their own candidates to the management's proxy statement.[229] Before proxy access became widely available, shareholders wanting to replace a director in the event of unsatisfactory performance had to bear their own proxy-campaign expenses.[230] Proxy access provides shareholders with a cost-free right to nominate a director, making it easier for them to replace incumbents. As governance scholars have explained, "[t]he primary benefits of proxy access would result not so much

229. *In-Depth: Proxy Access*, GLASS LEWIS 1-2 (Mar. 2016), https://www.glasslewis.com/wp-content/uploads/2016/03/2016-In-Depth-Proxy-Access.pdf [https://perma.cc/9LPV-N8FV].

230. Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 335-36 (2010).

from its use, but from its . . . general effect on directors' incentives," making them more accountable to shareholders.[231]

The U.S. Securities and Exchange Commission (SEC) first proposed formal rules dealing with proxy access in 2003 to grant shareholders the right to nominate directors without having to incur the costs associated with a proxy fight.[232] However, proxy access was not widely adopted until 2015, when large institutional investors and pension funds started to lead proxy access initiatives.[233] In particular, the Boardroom Accountability Project launched by the New York City Comptroller in 2014 involved extensive submissions of proxy access proposals to public companies.[234]

Figure 5 below vividly illustrates the distribution of proxy access provisions in the market as well as the limitation of private ordering. As seen, larger companies, specifically those within the S&P 500, are more likely to allow for proxy access than smaller companies. Until 2009, S&P 500 companies were the only ones to have adopted proxy access. In 2015, 14% of the S&P 500 allowed proxy access. By 2020, this number was more than five times higher, with 81% of the S&P 500 companies allowing such access. Smaller companies lagged significantly behind with only 34%, 14%, and 6% of the S&P 400, S&P 600, and Bottom 200, respectively, granting this right. Moreover, the rate of adoption in smaller companies was also much lower. In 2014, S&P 400 companies and Bottom 200 companies were identical in their levels of lack of proxy access. By 2020, over 30% of the S&P 400 had adopted such measures, while only 6% of the Bottom 200 had done the same.

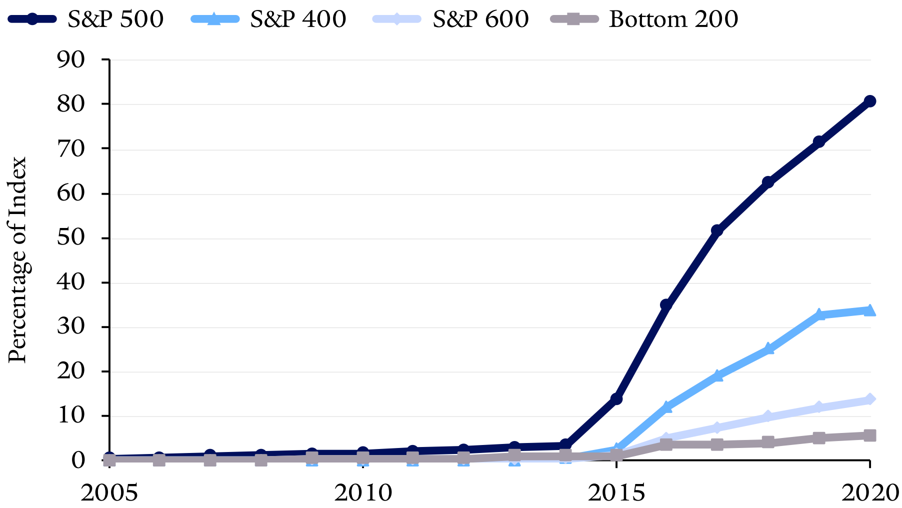
231. *Id.* at 336.

232. *See* Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 43, 48-64 (2003).

233. Gregory et al., *supra* note 19.

234. *See Boardroom Accountability Project: Overview*, N.Y.C. COMPTROLLER, https://comptroller.nyc.gov/services/financial-matters/boardroom-accountability-project/overview [https://perma.cc/VQ6A-54HG].

FIGURE 5. PROXY ACCESS IMPLEMENTATION



3. *Board of Directors*

The board of directors remains the heart of the corporation and plays a crucial role in its corporate governance framework.[235] The board of directors is generally evaluated in terms of its prominent structural attributes, including independence of the directors and chair, diversity and composition, tenure, age, and director busyness.[236] In this Section, we examine to what extent boards of large firms differ from those of small companies across each of these important dimensions.

We find that boards of large companies are more diverse and have a higher percentage of independent directors (including chairs of the board) compared with boards of small companies. However, small companies typically have younger directors with shorter board tenures and directors who serve on fewer boards at the same time.

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235. *See* Melvin Aron Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, 375-76 (1975) (discussing the origins of the board of directors as the core of modern corporate decision-making); Nili, *supra* note 146, at 42.

236. *See, e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0—An Introduction*, 74 BUS. LAW. 351, 356 (2019); Yaron Nili, *The Fallacy of Director Independence*, 2020 WIS. L. REV. 491, 493 [hereinafter *Fallacy*]; Jeremy McClane & Yaron Nili, *Social Corporate Governance*, 89 GEO. WASH. L. REV. 932, 937, 943-44, 973 (2021); Yaron Nili, *Board Gatekeepers* 45-46 (2021) (unpublished manuscript) (on file with author) [hereinafter *Gatekeepers*].

What explains these differences? In our view, two major factors affect board structure in small companies. First, when shareholders are the major driving force behind certain initiatives, such as enhancing board independence and increasing gender diversity, the smaller the company, the less likely such changes are to be implemented due to the structural-incentives problem discussed in the previous Section.

Second, other features are more influenced by the specific characteristics of small firms. Since these firms are, on average, less mature or established, their boards are smaller and the directors serving on them are also younger, with shorter tenure, and probably less experienced than directors of larger companies. Moreover, small companies are more likely to have a controlling shareholder or a founder who typically serves as chair of the board.[237] This, in turn, reduces the likelihood that a professional CEO will also serve as chair of the board.

a. Board Independence

An important aspect of the board's role is monitoring management and preventing misconduct.[238] Accordingly, investors have started prioritizing director independence on boards.[239] Independent directors are presumed to be less beholden to management;[240] therefore, increasing their presence on boards should improve the boards' effectiveness in monitoring management.[241] While this increasing reliance on independent directors is not without criticism,[242] institutional investors have placed significant emphasis on increasing board independence, viewing it as a better way to protect their interests.[243]

Our data reveal two major findings with respect to board independence. First, within the S&P 1500, the average percentage of independent directors on

237. *See, e.g.*, Papadopoulos, *supra* note 90.

238. Nili, *Gatekeepers*, *supra* note 236, at 6, 8.

239. *See, e.g.*, Nili, *Fallacy*, *supra* note 236, at 502; Urska Velikonja, *The Political Economy of Board Independence*, 92 N.C. L. REV. 855, 873-92 (2014).

240. Nili, *Gatekeepers*, *supra* note 236, at 10.

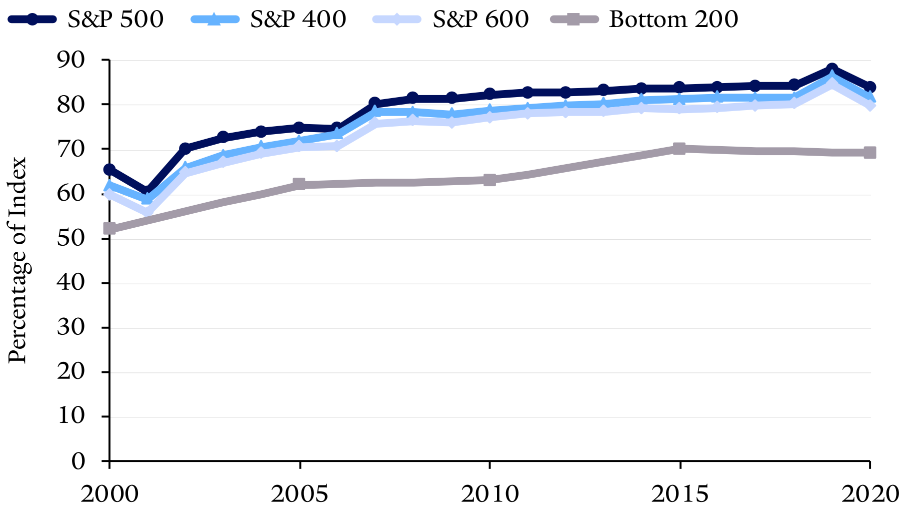
241. *Cf. id.* (describing shareholders "lauding [director] independence as the best way to achieve effective monitoring" of management).

242. *See, e.g.*, Lucian A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1284-92 (2017); Gilson & Gordon, *supra* note 236, at 356; Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 153 (2010); Nili, *Fallacy*, *supra* note 236, at 503; Gregory H. Shill, *The Independent Board as Shield*, 77 WASH. & LEE L. REV. 1811, 1811-12 (2020); Velikonja, *supra* note 239, at 855-56.

243. *See* Gilson & Gordon, *supra* note 236, at 356.

boards has increased from 62% in 2000 to a peak of 86% in 2019.[244] Second, and most importantly, large companies tend to have more independent directors. The companies in the Bottom 200 are more likely to have nonindependent board members compared with the S&P 1500. In 2020, 84% of the board members in the S&P 500 were independent, compared with only 69% of the Bottom 200.

FIGURE 6. TRENDS IN BOARD INDEPENDENCE



We also examine whether companies included in our sample have CEOs who also serve as chair of the board[245] and whether the chair of the board would be an independent director if these roles were separated. Shortly after the financial crisis of 2008, investors began advocating for separation of the CEO and chair roles, arguing that this would increase the board's independence from management and improve monitoring and oversight.[246] Indeed, we find that many large

244. These data align with data from previous studies. *See, e.g.*, Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1474-75 figs.1 & 2 (2007).

245. Aiyesha Dey, Ellen Engel & Xiaohui Liu, *CEO and Board Chair Roles: To Split or Not to Split?*, 17 J. CORP. FIN. 1595, 1595 (2011).

246. *See, e.g.*, *Proxy Firms Recommend JPMorgan Shareholders Vote Against Pay Plan*, REUTERS (May 6, 2015), www.reuters.com/article/us-jpmorgan-pay/proxy-firms-recommend-jpmorgan-shareholders-vote-against-pay-plan-idUSKBN0NR1XY20150506 [https://perma.cc/3TWQ-9R6M] (reporting that the proxy advisory firms ISS and Glass Lewis recommended stripping JPMorgan Chase Chief Executive Officer (CEO) Jamie Dimon of his chairmanship); John Laide, *Issue Focus: Separate Chairman and CEO*, SHARK REPELLENT (Sept. 18, 2015),

companies have been attentive to these pressures, resulting in a significant decline in the number of companies in the S&P 500 with a dual CEO-Chair from 2007 to 2020. In 2007, about 60% of the companies in the S&P 500 had a dual CEO-Chair, and such proportion decreased to 43% in 2020. Most importantly, we find that large companies are also more likely to have an independent chairman who is not an employee of the company. For example, in 2020, 52% of the companies in the S&P 500 had an independent Chair, compared with 32% in a sample of 200 companies in the S&P 600.[247]

b. Board Gender Diversity

In addition to board independence, investors, scholars, and policy makers have been advocating for greater gender diversity on boards.[248] Indeed, in recent years, the need to increase gender diversity in the boardroom has become one of the hottest issues that public companies face.[249] With prominent institutional

[https://perma.cc/V8ML-4NBJ?type=image] (reporting that shareholder activists have continuously lobbied companies to appoint an independent chairman); *see also* Matteo Tonello, *Separation of Chair and CEO Roles*, HARV. L. SCH. F. ON CORP. GOV. (Sept. 1, 2011), https://corpgov.law.harvard.edu/2011/09/01/separation-of-chair-and-ceo-roles [https://perma.cc/PVY4-Z6ZM] (explaining that after financial crises such as the one in 2008, "the issue of separating the chair/CEOs roles is often front and center . . ."); Yaron Nili, *Successor CEOs*, 99 B.U. L. REV. 787, 804-16 (2019) (explaining that corporations increasingly separate the chairperson and CEO roles due to pressure from shareholders, institutional investors, and proxy advisory firms).

247. Boards of small companies generally tend to have a lower percentage of dual CEO-Chairs compared to large companies. For example, in 2020, 31% and 33% of the companies that make up the S&P 600 and S&P 400, respectively, had a dual CEO-Chair, compared to 43% of the companies in the S&P 500. However, we note an upward trend in the unification of these roles among S&P 400 and S&P 600 companies in recent years. More importantly, even when the roles are separated, these companies are less likely to have independent chairs, and instead, they appoint another insider (such as the company founder) as the separate chair.

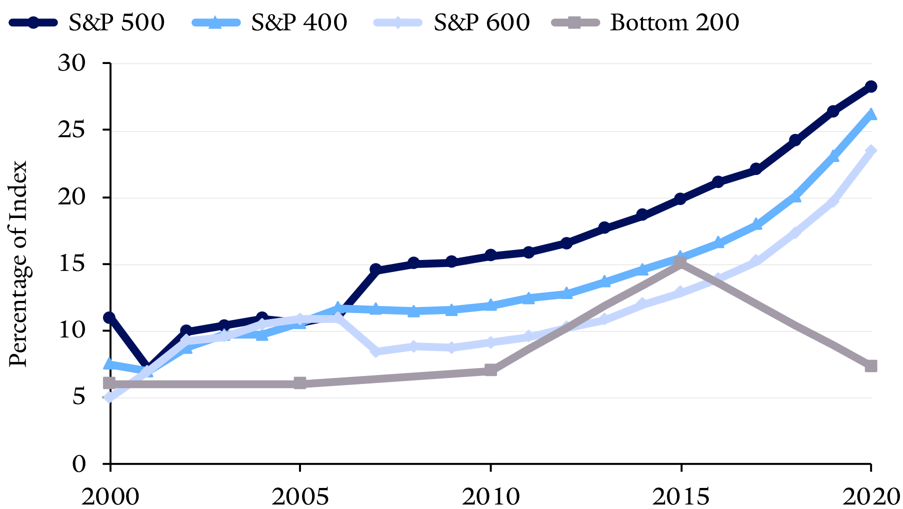
248. Yaron Nili, *Beyond the Numbers: Substantive Gender Diversity in Boardrooms*, 94 IND. L.J. 145, 147-48 (2019). In 2018, California became the first state to mandate that public companies headquartered in California have at least one woman on the board. CAL. CORP. CODE § 301.3(a) (West 2021). Other states have since followed. *See* Martha Groves, *How California's 'Woman Quota' Is Already Changing Corporate Boards*, CALMATTERS (Dec. 16, 2019), https://calmatters.org/economy/2019/12/california-woman-quota-corporate-board-gender-diversity [https://perma.cc/DV6B-6B67] (explaining that Massachusetts and New Jersey have introduced similar proposals). In 2020, California passed a similar law that requires public companies headquartered in California to include members from underrepresented communities on the board. CAL. CORP. CODE § 301.4(a) (West 2021).

249. Nili, *supra* note 248, at 155-56.

investors such as BlackRock, State Street, and Vanguard declaring their commitment to this issue, it is not surprising that the number of proposals seeking to increase the number of women in the boardroom has reached an all-time high.[250]

But this important trend has not unfolded uniformly across all firms. Smaller companies are less diverse and have lower percentages of women on their boards. This gap has been growing over the past fifteen years. As depicted in Figure 7 below, from 2000 to 2006, companies of all sizes had an average of 9% female board directors. However, since 2007, there has been a greater percentage of female board directors in the S&P 500 compared to all other indexes, and while female representation in other S&P indexes also increased over the past decade, gaps still persist. In the smallest companies, the gap is even greater. For example, in 2020, female directors made up just 7% of the board members of the Bottom 200 companies, compared with 28%, 26%, and 23% for the S&P 500, S&P 400, and S&P 600, respectively.

FIGURE 7. HISTORICAL PERCENTAGE OF FEMALE DIRECTORS



c. *Board Age and Tenure*

Two additional prominent structural attributes of the board that have received significant attention from investors are directors' tenure and age.[251] Our data reveal two major findings with respect to how board tenure and age differ

250. *Id.* at 155.

251. *See, e.g.*, Yaron Nili, *The "New Insiders": Rethinking Independent Directors' Tenure*, 68 HASTINGS L.J. 97, 117-30, 139 (2016).

based on firm size. First, as shown in Figure 8 below, large- or mid-cap companies typically have a longer board tenure compared to small companies. In 2020, the average maximum board tenure was about ten years less for the Bottom 200 than the S&P 500. Second, directors of Bottom 200 companies are younger. For example, in 2020, directors at Bottom 200 companies were one to two years younger than those at S&P 1500 companies.

FIGURE 8. 2020 BOARD AGE AND BOARD TENURE BY INDEX

	BOARD AGE			
	S&P 500	S&P 400	S&P 600	BOTTOM 200
AVERAGE	63	63	63	61
MAX	74	74	74	73
MEDIAN	63	63	63	62
	BOARD TENURE			
	S&P 500	S&P 400	S&P 600	BOTTOM 200
AVERAGE	10	10	9	7
MAX	25	24	22	16
MEDIAN	8.0	8.7	8.1	6.5

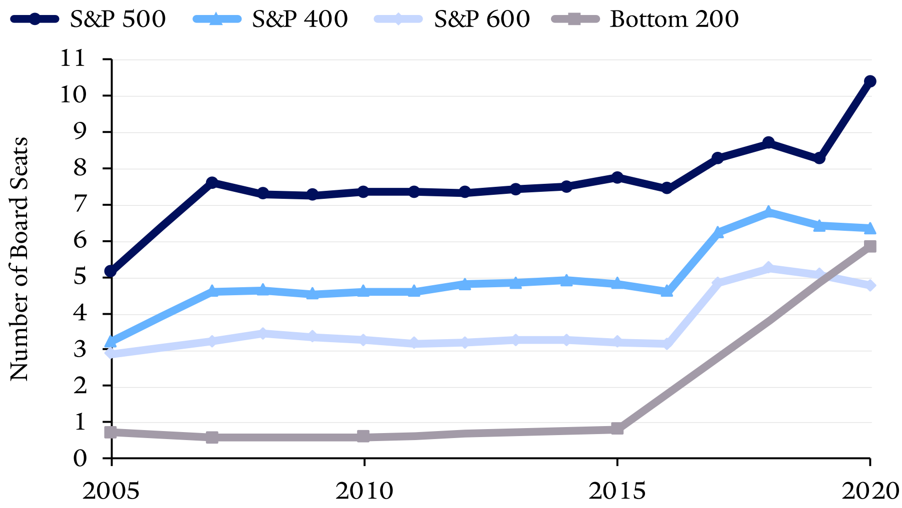
d. Additional Directorships

The large companies that make up the S&P 500 are also more likely to have directors who sit on other boards. Over the last fifteen years, the average number of other corporate boards represented by the director of a company within the S&P 500 was 7.8 boards, compared with 5.2 boards for the S&P 400 and 3.7 boards for the S&P 600.

This gap is even more pronounced when we examine additional directorships of companies in the Bottom 200. For example, in 2020, the average number of other corporate boards on which the director of a company within the S&P 500 also served was 10.4 boards, compared with 5.8 boards within the Bottom 200. Overall, these data suggest that directors of companies with smaller market capitalizations are serving on fewer boards for shorter periods of time. Although this may indicate board independence in these companies, it also means that these directors lack board experience and expertise compared with directors of larger companies. And service on other boards has been shown to be important for corporate governance,[252] again putting smaller companies at a disadvantage.

252. *See, e.g.*, McClane & Nili, *supra* note 236, at 961-80.

FIGURE 9. AVERAGE NUMBER OF OTHER BOARD SEATS HELD BY DIRECTORS (CUMULATIVE PER COMPANY)



B. Shareholder Activism Data

Part I described the rise of activist shareholders who submit shareholder proposals on a large scale to pressure management to adopt certain governance standards, as well as the emergence of hedge funds that directly engage with management through proxy fights, other public campaigns, or private communications.[253] This Section empirically examines the extent to which small companies are subject to shareholder activism.

Overall, the activism data reveal an interesting division of labor: large companies have significantly greater exposure to "governance" activism, or soft activism, compared with small companies. This type of activism mostly involves the submission of shareholder proposals and exempt solicitations. We also find that prominent institutional investors devote greater resources to engagements with large companies. Taken together, these data help explain the creation and sustainment of the governance gap we documented in Section II.A.

However, small companies have greater exposure to the most aggressive type of hedge-fund activism: proxy fights for the nomination of activist directors to the board. While proxy fights constitute only a small fraction of shareholder activism in large companies, they are the most common type of activism in small

253. For a detailed review, see *supra* Sections I.A and I.B.2.c.

companies. Because this activity is still limited in its scope and objectives, however, it is unlikely to mitigate the Corporate Governance Gap.

1. *Methodology*

We collected data from various sources to conduct our analysis. First, we obtained data on shareholder proposals submitted to all public companies from 2005 to 2020 from the FactSet database. We then sorted the data by index type—S&P 500, S&P 400, S&P 600, and all other public companies (that is, the small-cap universe)—to analyze how the submission of shareholder proposals varies across the different indexes and over time.

Second, we collected data from the FactSet database on other types of activist engagement with public companies from 2005 to 2020 and sorted them by index type. These data include information on all proxy fights, exempt solicitations, and other shareholder campaigns for companies included in the aforementioned indexes and time period.[254] We also collected information on the different types of demands made by activist investors in the course of those engagements, as well as their stated goals. In addition, to account for differences in the size of the indexes, we divided each yearly number of activist engagements by the total number of companies in each index. Such adjustment allows for a comparison of the intensity of activist engagements within indexes of differing sizes.

2. *Shareholder Proposals*

The submission of shareholder proposals has become a key avenue through which shareholders can pressure management to adopt certain governance standards.[255] The frequent use and follow-up implementation rate of shareholder proposals reflect both the ability to submit proposals at a low cost and the increased attention these proposals receive.[256] The data reveal a relatively steady and significant number of shareholder proposals submitted to the S&P 1500 from 2005 to 2020. On average, over 680 shareholder proposals, or around 80% of all shareholder proposals submitted to public companies in the United States, were submitted each year during this period within the S&P 1500.

Most importantly, our data show that the proposal submissions are not distributed equally between large-, mid-, and small-cap firms. As Figure 10 below shows, larger companies received the vast majority of proposals. In 2020, about

254. For definitions of these three categories, see *infra* Section II.B.3.

255. For a comprehensive discussion on the effect of shareholder proposals, see *supra* Section I.B.2.b.

256. *See* Kastiel & Nili, *supra* note 50, at 587-88.

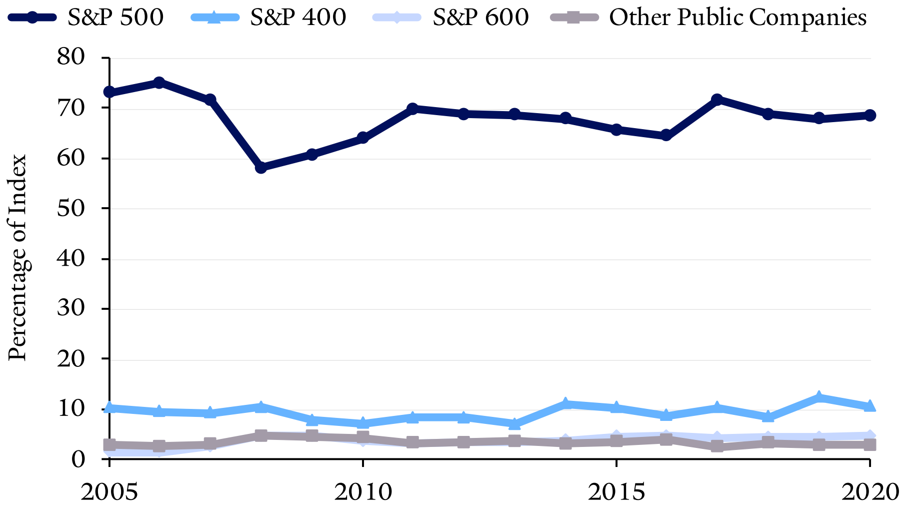
70% of all proposals were submitted to the large-cap companies that compose the S&P 500. In contrast, fewer than 15% of all proposals were submitted to the S&P 400 and S&P 600 combined, and the final 15% were submitted to 2,000 public companies outside the S&P 1500. As discussed above, the discrepancy between the number of proposals submitted by shareholders to large companies and those submitted to small- and mid-cap companies may be related to the widespread press coverage that large companies receive[257] and insufficient incentives for investors to engage with small firms.

Our data on the submission of shareholder proposals also help explain the creation and perpetuation of the governance gap we documented in Section II.A. At the IPO stage, many companies, large and small, tend to adopt entrenchment devices and governance terms that investors disfavor. For example, an IPO survey from 2018 shows that 90% of the companies that went public without a controlling shareholder adopted a classified board.[258] This was followed by activist shareholders using the submission of shareholder proposals as a major tool to amend those provisions. But, since the vast majority of the proposals are submitted to large firms, a governance gap is created, leaving small and mid-cap companies behind with a higher percentage of governance terms that investors disfavor.

257. *Id.* at 582.

258. *Corporate Governance Practices in U.S. Initial Public Offerings (Excluding Controlled Companies)*, DAVIS POLK 13 (July 2018), https://www.davispolk.com/files/2018_non-controlled_ipo_survey.7.9.2018.pdf [https://perma.cc/7CLG-BD6R]. For additional research discussing the adoption of antitakeover devices at the IPO stage, see Bebchuk, *supra* note 86, 719-20, which discusses managers' perverse incentives; and Klausner, *supra* note 85, at 1370.

FIGURE 10. SUBMITTED SHAREHOLDER PROPOSALS BY INDEX



3. *Activist Campaigns*

Data on activist engagements differ according to their level of intensity, the actions involved, and their purported goals. The softest type of activism is "exempt solicitations." These solicitations, which are exempt from disclosure rules pursuant to SEC Rule 14a-2(b)(1) of the Securities Exchange Act of 1934, usually involve dissident communications to shareholders to persuade them to vote for or against a shareholder proposal.[259] A more aggressive type of activism is a "proxy fight." FactSet defines a "proxy fight" as a campaign that usually involves seeking the election of dissident nominees to the company's board of directors in opposition to the company's director nominees.[260]

a. *Exempt Solicitations*

Large companies are substantially more likely to be subject to exempt solicitations. In 2020, around 80% of all exempt solicitations were targeted at the S&P 500, contrasted with only 11%, 4%, and 2% of all exempt solicitations for the S&P 400, S&P 600, and all other public companies, respectively.

As Figure 11 demonstrates, shareholders of companies within the S&P 500 started bringing more exempt solicitations as of 2012. While in 2011 only 5% of

259. 17 C.F.R. § 240.14a-2(b)(1) (2021).

260. These terms are defined in the glossary of the FactSet database.

S&P 500 companies were subject to exempt solicitations, this percentage grew to 30% in 2020. This is in contrast to much lower rates of involvement in small and mid-cap companies, which vary between 1% and 5%.

What can explain this immense gap? The first place to look is the type of activist investors who engage in exempt solicitations and the goal of these solicitations. Exempt solicitation is an inexpensive way to influence the governance structure of public firms without bearing the heavy costs of disclosure requirements associated with unexempt activities. Our data show that it is institutional investors, activist nonprofit organizations, and individual shareholders who tend to engage in this soft form of activism. These investors tend to prioritize their targets and focus on large companies because larger companies constitute a larger fraction of their portfolio. Large companies also receive more press coverage and face greater societal pressures for board accountability.[261] Therefore, they are more likely to follow softer types of engagements in order to preempt additional interventions by activist shareholders.[262]

In over 80% of all exempt solicitations across the various indexes, the dissident used the exempt solicitation to urge shareholders to vote for a particular shareholder proposal related to governance enhancements, and 10% of all exempt solicitations were intended to communicate their disapproval of management's proposals. Over 96% of the exempt solicitations made within the S&P 500 are related to governance demands, compared with only 52% of the exempt solicitations for other public companies.

Overall, these data provide additional evidence of the strong concentration of market participants in large firms and their tendency to overlook small firms. The data are also consistent with our findings on the submission of shareholder proposals, showing that large companies tend to be the major targets for soft-form activism aimed at amending major governance terms of these firms.

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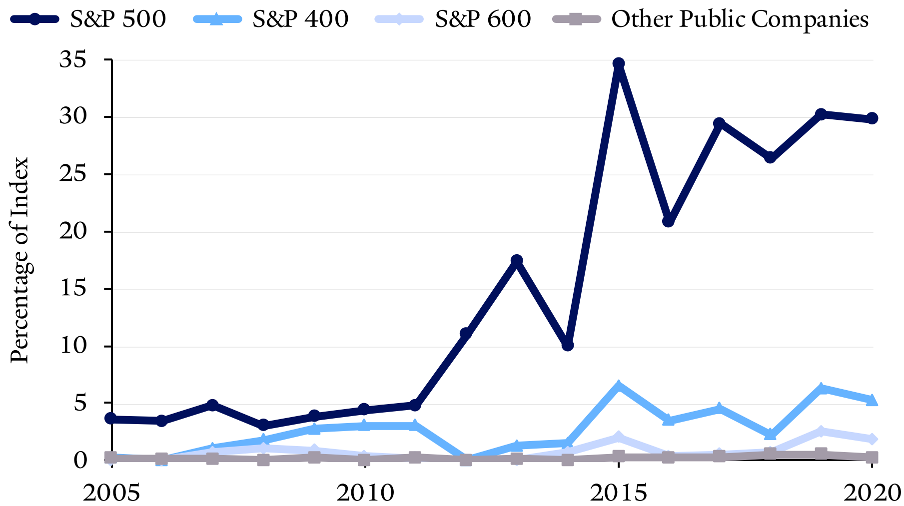
261. *See supra* Section I.B.2.

262. Douglas Chia & Lex Suvanto, *Boards Beware: Accountability Is Rising*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 5, 2020), https://corpgov.law.harvard.edu/2020/12/05/boards-beware-accountability-is-rising [https://perma.cc/7H2W-26UD].

FIGURE 11. PERCENTAGE OF COMPANIES SUBJECT TO EXEMPT SOLICITATION (BY INDEX)



b. Proxy Fights

Campaigns that involve the nomination of activist candidates to the board (that is, a proxy fight) are the most aggressive type of activism and are handled mostly by hedge funds. As we predicted in Section I.B., small companies are likely to be easier and more attractive targets for hedge-fund activism, as it is less expensive to amass a large enough stake to effect change if a company has a small market cap. About 2.5% of the companies that make up the S&P 400 and S&P 600 and 2% of the smallest companies that are outside the S&P 1500 were subject to a proxy fight in 2020, compared with slightly less than 1% of the companies in S&P 500.[263] This difference persists throughout our entire sample period.[264]

263. *See also Review and Analysis of 2020 U.S. Shareholder Activism and Activist Settlement Agreements*, *supra* note 141, at 21 (showing that activists target smaller companies in greater proportions, with companies with a market capitalization between $100-$500 million experiencing 45% of activist campaigns in 2020 but collectively representing only 26% of the Russell 3000 Index).

264. Activist investors also engage in campaigns that take the form of communications to management through letters or Schedule 13D filings that only threaten, but do not amount to, a proxy fight (FactSet often defines those campaigns as "Other Stockholder Campaigns"). The data on these campaigns exhibit a similar pattern to proxy fights. In particular, although there has been an increase in the number of non-proxy-fight campaigns in smaller companies between 2011 and 2020, only a small fraction of these companies were subject to them. For example, only 2.5%, 2%, and 1% of the companies in the S&P 400, S&P 600, and other public companies, respectively, were subject to these activist campaigns in 2020.

Proxy fights, however, cannot mitigate the governance gap. First, the very limited number of engagements with small and mid-size firms each year does not amount to an adequate substitute for other forms of engagement or activism. Moreover, the hedge funds involved in engagements with small firms are often less experienced and resourceful. This, in turn, may affect the quality of the engagements.[265] Finally, hedge-fund engagements with small companies tend to have different objectives and focus less on governance matters.[266]

C. Ownership Data and Engagement

As explained in Section I.B.2.e, ownership structure could impede the ability of activist shareholders to engage with target companies in two major ways. To begin with, when the company's equity ownership is concentrated in the hands of insiders, activists have limited ability to influence the vote outcome, and thus their incentives to engage with target firms decrease. Second, activists also encounter greater difficulties engaging with targets that have a lower proportion of institutional ownership and a higher percentage of retail investors who tend not to participate in the voting process.

With those assumptions in mind, we turn to examine how ownership structure varies based on firm size and how ownership structure affects engagements by the most prominent institutional investors. To explore data on shareholder ownership and institutional investor engagement, we collected and compiled historical data from the FactSet database on the average institutional-ownership percentage (the aggregate ownership interest of all institutional investors) and insider-ownership percentage (the aggregate ownership interest of company insiders) for all companies within the S&P 1500 and the Bottom 200 of the Russell 3000 for each year from 2000 to 2020.

Our data show that companies that make up the Bottom 200 have a much higher average insider-ownership percentage compared with the S&P 1500. The average insider-ownership percentage for the last twenty years was 32% for the Bottom 200 compared with 13%, 9%, and 5% for the S&P 600, S&P 400, and S&P 500, respectively.

Small companies also tend to have a lower percentage of institutional ownership, although the difference in this respect between large and small companies has decreased over the last twenty years. In 2000, the average proportions of

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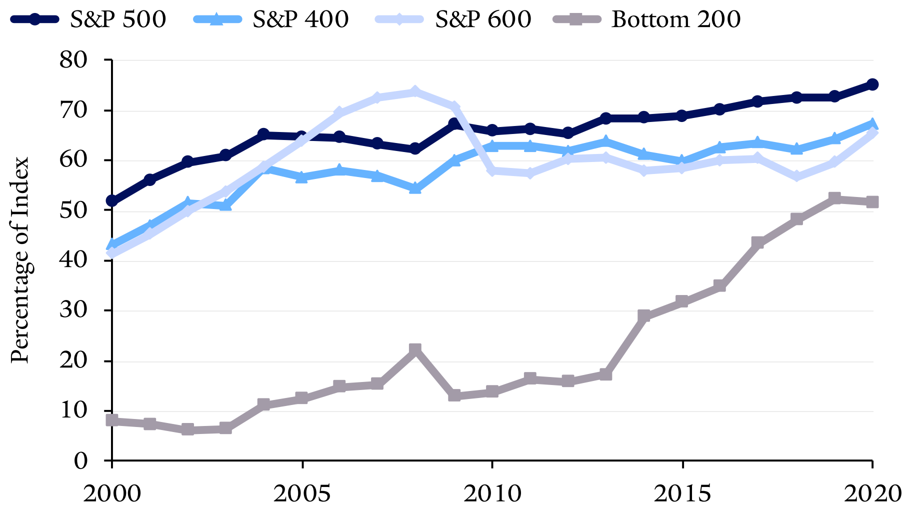
265. *See supra* Section I.B.2.c (discussing the contrast between hedge funds engaged with small firms and ones engaged with large firms).

266. For example, shareholders launching a proxy fight against public companies outside the S&P 1500 made almost 125% more value demands than governance demands. In contrast, engagements within the S&P 1500 have generally launched as many proxy fights with value demands as they have with governance demands.

institutional ownership for the S&P 500, S&P 400, and S&P 600 were 52%, 43%, and 41%, respectively. However, the average institutional-ownership percentage for the Bottom 200 was only 8%—more than six times lower than in the S&P 500. The difference between the average institutional-ownership percentage for the S&P 500 and the Bottom 200 has diminished, as shown in Figure 12 below. The marked increase in the Bottom 200 institutional-ownership percentage, however, did not translate to a significant narrowing of the governance gap between these companies. This further supports Section II.B's findings that larger investors focus their efforts on larger companies. Despite large investors' increased ownership in smaller companies, their governance making channels have remained less effective.

FIGURE 12. PERCENTAGE OF INSTITUTIONAL OWNERSHIP



We also examine engagements of the three largest institutional investors—BlackRock, State Street, and Vanguard, often referred to as the "Big Three" indexing giants of Wall Street—with public companies.[267] Scholars argue that the Big Three are better positioned than any other shareholders to set market-wide governance standards given their influence, broad ownership, and focus on corporate governance.[268] But how often do they engage with public companies and to what extent does the size of these companies matter?

267. Kastiel & Nili, *supra* note 50, at 599.

268. *See, e.g.*, Bebchuk & Hirst, *supra* note 103, at 2105-06; Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771, 1807-08 (2020).

Using annual stewardship reports, we hand collected and compiled a list of all public companies with which the Big Three have engaged in the last two years.[269] We then compared this list of engagements with information from the FactSet database to identify the index or market capitalization for each company.

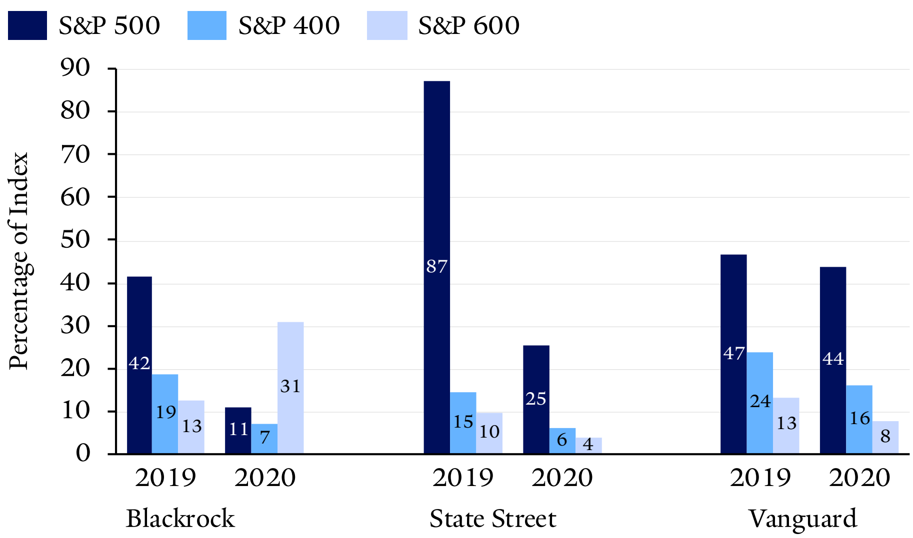
Our data reveal two main findings. First, many companies are not subject to engagements by the Big Three. Second, the Big Three are more likely to engage with companies within the S&P 500 than with any other companies. For example, in 2020, State Street engaged with 25% of the companies in the S&P 500, but with only 4% of the companies in the S&P 600. Similarly, Vanguard engaged with 44% of the companies in the S&P 500, but only with 8% of the companies in the S&P 600. The previous year, 2019, provides somewhat similar results for these two giants, showing the heavy focus on S&P 500 companies. BlackRock is the only institutional investor that conducted a large number of engagements with small firms in 2020, but in 2019, large companies were three times as likely to be the subject of an engagement with BlackRock compared to small-cap companies.[270] Our data are also in line with a recent empirical study, which finds that large investors focus their engagement efforts on the largest firms in which they hold a significant stake.[271]

269. *See* BLACKROCK, 2019 INVESTMENT STEWARDSHIP ANNUAL REPORT (2019); BLACKROCK, INVESTMENT STEWARDSHIP ANNUAL REPORT (2020); STATE ST. GLOB. ADVISORS, STEWARDSHIP REPORT 2018-19 (2020); STATE ST. GLOB. ADVISORS, STEWARDSHIP REPORT 2020 (2021); VANGUARD, INVESTMENT STEWARDSHIP: 2019 ANNUAL REPORT (2019); VANGUARD, INVESTMENT STEWARDSHIP: 2020 ANNUAL REPORT (2020).

270. Similarly, data we hand collected regarding BlackRock engagements in 2018 show that BlackRock engaged with 48% of the companies in the S&P 500, but with only with 21% of the companies in the S&P 600. BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: 2018 ANNUAL REPORT (2018). Data on the engagements of Vanguard and State Street in 2018 are not publicly available.

271. *See supra* notes 101-102 and accompanying text.

FIGURE 13. PERCENTAGE OF COMPANIES (PER INDEX) ENGAGED WITH BY THE BIG THREE IN 2019-2020



D. The Gap Is Not Merely a Function of Small Firms' Unique Attributes

Examining all the data, our empirical analysis shows a consistent pattern with respect to the dissemination of governance terms in the market. While we have seen a sharp increase in the adoption of governance practices favored by public shareholders over the past twenty years, this trend has not advanced uniformly. In fact, there is a significant divide between large, publicly traded firms and smaller ones, with the latter granting fewer protections to their investors and being less likely to adopt these protections even when many large companies do. What drives this governance gap?

One potential argument is that the governance gap we identify is merely a function of the unique attributes of smaller firms, which may tend to have a higher proportion of controlling shareholders, to be newer to the public market, or to be more subject to takeover or activism due to size. Each of these different attributes, rather than any potential deficiencies in the channels of governance making, could potentially explain the gap in governance arrangements as a function of idiosyncratic characteristics of smaller companies. This Section shows why the gap is unlikely to be explained by the likelihood of takeover threat, firm age, or the presence of a controlling shareholder.

First, the threat of hostile takeovers: in theory, larger firms have fewer entrenchment mechanisms simply because senior managers and directors in these firms are effectively protected due to firm size, and therefore do not need protective governance provisions.[272] Smaller firms, in contrast, are more susceptible to takeovers and activism and thus may have a greater need for antitakeover devices to protect themselves from hostile acquirers.[273]

There are good reasons for questioning this explanation. To begin with, the opposition of large investors to the use of entrenchment devices is not conditioned on firm size. Rather, shareholders express clear opposition to these devices across the board, regardless of whether they are implemented in small or large companies.[274] Moreover, as Sections II.A and II.C demonstrate, shareholders who initiate governance changes submit substantially fewer proposals to small firms in the first place. This finding holds with respect to all governance- and board-related matters, even those that are unrelated to entrenchment devices. Consider, for example, the dissemination of proxy access provisions, which are not perceived as an antitakeover device, in the market. There is no clear reason why public shareholders in smaller companies should be more limited in their ability to nominate minority directors. Similarly, there is no persuasive explanation as to why small firms are subject to a lower number of engagements by the Big Three but for the fact that large investors have significant incentives to focus their engagement efforts on the largest firms in which they hold a larger equity stake.[275]

Second, one could attempt to justify the gap by claiming that small firms are still growing and insulation from market forces is especially valuable for them.[276] The argument is particularly appealing if smaller firms are also younger companies with volatile value in the years following their IPO and with less time to adjust their governance based on shareholder input. If smaller companies are significantly younger, one may indeed worry that the gap we identify is a function of *age* rather than *size*.

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272. Garvis, *supra* note 172, at 191.

273. A related argument is that antitakeover devices enable founders of small firms to pursue freely their idiosyncratic visions. *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 565-66 (2016).

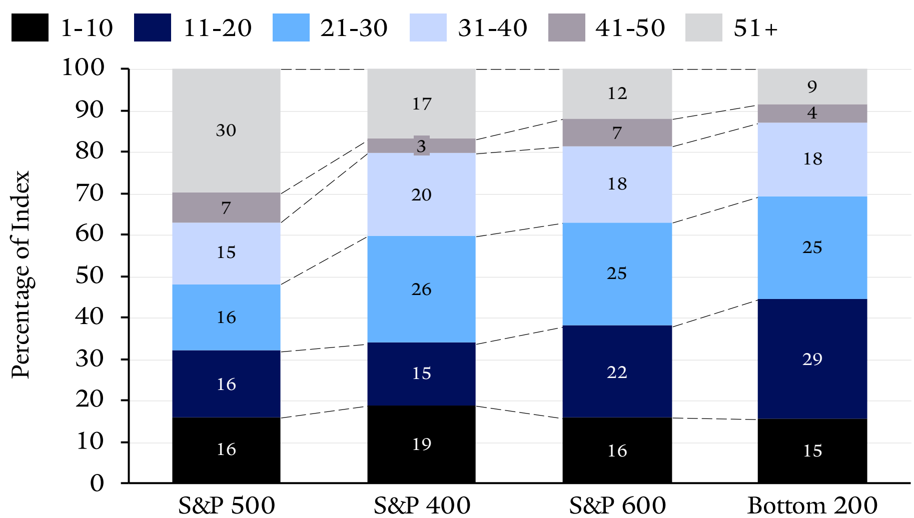
274. *See, e.g.*, sources cited *supra* note 214.

275. We note that proxy fights by activist hedge funds are more common in smaller companies, but these funds have limited resources. Since they tend to acquire large stakes in a small number of public companies, they can be involved in only a limited number of engagements with small or mid-size firms each year. Their activity thus does not amount to an adequate substitute for other forms of activism. *See* discussion *supra* Sections I.B.2.c and II.B.3.

276. *See, e.g.*, William C. Johnson, Jonathan M. Karpoff & Sangho Yi, *The Lifecycle Effects of Corporate Takeover Defenses* 5 (Eur. Corp. Governance Inst., Fin. Working Paper No. 761, 2021), https://ssrn.com/abstract=2808208 [https://perma.cc/Z83G-2YZ5].

We used the methodology described in Section II.A to explore the ages of the companies in our sample. Figure 14 below presents the information on firm age by ten-year increments and by index. As Figure 14 below demonstrates, company age is not a driving factor of the gap. Indeed, the proportion of firms that are less than ten years old is practically identical across the different indexes and is not significantly different even when looking at the time window of twenty years or more of past incorporation for all companies outside the S&P 500. A set of untabulated regression analyses we conducted confirms that our results hold across our various governance measures, even when controlling for company age, whether measured since IPO or since incorporation.

FIGURE 14. COMPANY AGE



One might instead argue that since there is a general trend in small companies towards the adoption of governance provisions that shareholders generally support (with the exception of classified boards), we should be patient and give these companies time to "catch up."

But our data raise doubt that this is the right way to view the time trends. First, our data consistently show that the gap is maintained over time. That is, even if some small firms amend their governance terms, this trend certainly does not necessarily close the gap. Second, waiting ten to fifteen years for small companies to catch up is still a significant period of time during which companies lack governance arrangements that shareholders view as optimal. Finally, corporate governance arrangements change over time. New practices develop (such as proxy access), and new emphasis is given to old issues (such as board diversity and independence). Even if smaller companies would eventually catch up on older trends, they are still behind on the adoption of new and emerging governance practices. In that sense, the slow speed with which governance arrangements are adopted in smaller firms harms both current and future governance practices.

Finally, if smaller companies are indeed more prone to have controlling shareholders, one could posit that the differences we identify are a product of the unique dynamics of companies with controlling shareholders, where changing governance terms would only occur if the controlling shareholder agreed to them. In other words, it could be *shareholding structure* rather than *size* that is driving our results. While appealing on its surface, the argument does not pan out in our data. First, as Figure 13 shows, a large proportion of the smaller companies are widely held, with a large and growing fraction of institutional ownership, yet the gap still persists.[277] Second, governance changes may be achieved through shareholder pressure despite the presence of a controlling shareholder.[278] And third, in a second set of untabulated regression analyses, we confirm that our results hold even when accounting for the presence of a controlling shareholder as a control variable in a regression model. This confirms that company size, regardless of the presence of a controlling shareholder, is significantly correlated with each of the governance metrics we identify.[279]

Taken together, company age or shareholdings are unlikely to explain our findings. In our view, the most plausible explanation for the empirical patterns observed in this Part is that the adoption of governance arrangements in small companies is less systematic, often representing a significant departure from the norms set by larger companies, because these companies receive limited attention from large institutional investors and other activist shareholders. Since these activist shareholders, who are the agents of governance changes, have limited resources, they need to prioritize their targets. They therefore tend to focus on large companies and allow small ones to fly under the radar. This explanation is also consistent with other empirical scholarship which highlights inefficiencies in the private-ordering process.[280]

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277. Our finding is further corroborated by recent empirical data provided by ISS on the limited number of controlled companies among small and mid-size companies. *See* Papadopoulos, *supra* note 90 (showing that controlled companies make up only 8.4% of the entire Russell 3000 and that only 20% of the CEOs of smaller, non-S&P 1500 companies in the Russell 3000 have voting power interests of 5% or more).

278. *See generally* Kastiel, *supra* note 149 (providing examples of activism against controlled companies while showing that the likelihood of activism is significantly lower in such situations).

279. The results still hold when controlling for both age and controlling shareholder.

280. *See supra* note 85 and accompanying text.

A sharp divide exists between America's largest corporations and its smaller ones. In smaller, less scrutinized corporations, the adoption of governance arrangements is less organized, often representing a significant departure from the norms set by larger companies that have been long celebrated by market participants. These findings raise an important question: what can be done to bridge this gap? Part III provides a path forward.

III. POLICY IMPLICATIONS

Large companies, showered with attention from investors, analysts, bankers, and the media, adopt governance provisions that incentivize their management to be more responsive to investors' wishes, to maintain a robust dialogue with them, and to populate their boards with experienced and diverse directors. On the other hand, small-size companies are deprived of that attention. Shareholders and other stakeholders often lack the tools or the incentives to shift these companies' default arrangements to the governance practices that are overwhelmingly adopted by larger companies.

Some may argue that the Corporate Governance Gap is a feature rather than a bug. On this view, the high barriers for initiating governance changes in smaller firms is a desirable outcome, as most small-firm shareholders are uninformed or suffer from conflicts of interest. Therefore, the argument goes, these deficiencies in governance making actually facilitate a diversity of governance arrangements among public companies by insulating smaller companies from market forces.

We acknowledge the importance of the ongoing debate regarding the appropriate role and power that shareholders should have in corporate governance. While we generally believe that giving shareholders an effective voice on the optimal governance arrangements of companies is important,[281] we recognize that some may hold a different view.

But it is important to note that shielding companies from the channels of governance making is unlikely to lead to a diversity of governance practices. First, many governance arrangements are binary in nature. That is, in many cases, governance diversity is limited to a menu of two possible outcomes. Either a company has a staggered board or it does not; either a company adopts majority voting or it does not. Insulating smaller companies from private ordering by investors is likely to shift the pendulum to a promanagerial governance structure and lead to a "one-size-fits-all" in the opposite direction.

281. *See* Kastiel & Nili, *supra* note 50, at 625-28; Kastiel & Nili, *supra* note 58, at 300-03. For empirical evidence on the costs of insulating management, see sources cited *supra* notes 208, 215-216.

Second, governance diversity is not only observed via the gap between large and small companies. As the data we present in Part II show, the governance terms of large and visible companies also vary, suggesting that investors in these companies do not always adopt the "one-size" approach even if they have the power to do so. Therefore, taking certain process-oriented measures that are not outcome-determinative to address the Corporate Governance Gap will not necessarily result in restricting governance diversity. Instead, it will help remedy the failure of the private-ordering mechanisms in smaller companies.

This Part discusses the significant implications of our theoretical and empirical analysis. Section III.A reviews the implications that this analysis has for investors, public officials, and researchers, and Section III.B addresses the implications for the debate on the regulation of proxy advisory services. Finally, Section III.C proposes a process-oriented solution to level the playing field by reducing existing barriers for initiating governance changes in small firms.

A. Investors, Public Officials, and Researchers

Reports and information on corporate governance in America have long been biased toward gathering and reporting about data and trends in large companies.[282] This bias creates a distorted picture of the corporate governance landscape, given that the reporting ignores the vastly different environment of companies outside of the spotlight. Spencer Stuart, for example, releases an annual report on board practices based on the yearly trends within the S&P 500.[283] Advisors cite this study as "a useful guide for benchmarking,"[284] and practitioners and activists use the report to evaluate the state of corporate governance in America.[285] Similarly, recent discussions regarding the rapid rise in proxy access explain that this practice has become mainstream at larger S&P 500 companies

282. *See, e.g.*, David A. Bell, *Corporate Governance: A Comparison of Large Public Companies and Silicon Valley Companies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 28, 2016), https://corpgov.law.harvard.edu/2016/11/28/corporate-governance-a-comparison-of-large-public-companies-and-silicon-valley-companies [https://perma.cc/88S6-2ETC].

283. *2018 United States Spencer Stuart Board Index*, SPENCER STUART (2018), https://www.spencerstuart.com/-/media/2018/october/ssbi_2018.pdf [https://perma.cc/3ZHV-KTUM]; *2019 U.S Spencer Stuart Board Index*, SPENCER STUART (2019), https://www.spencerstuart.com/-/media/2019/ssbi-2019/us_board_index_2019.pdf [https://perma.cc/85GB-PVDQ].

284. Chiu, *supra* note 19.

285. *Spencer Stuart—U.S Board Index 2018*, THIRTY PERCENT COAL. (2018), https://www.30percentcoalition.org/resources/references-research/spencer-stuart-u-s-board-index-2018 [https://perma.cc/TU8X-P67Z]; Scott A. Scanlon, Dale M. Zupsansky & Stephen Sawicki, *Independent Directors, Women and Minorities See Board Gains*, HUNT SCANLON MEDIA (Jan. 30, 2020), http://huntscanlon.com/independent-directors-women-and-minorities-see-board-gains [https://perma.cc/FG5F-LJB2].

without discussing its use at smaller companies.[286] Researchers have also devoted less attention to small firms, probably because data on those firms are not always publicly available and must be collected manually.[287] The lack of analysis and attention to the governance of smaller companies leaves these companies in a no-man's-land.

Our findings have direct implications for many participants in the corporate governance ecosystem. Here we highlight three key governance stakeholders and how the bifurcation of corporate governance should inform their future actions.

1. *Investors*

Many large investors must invest in smaller companies due to their index requirements.[288] Yet, too often, they have been allocating their limited governance-advocacy resources to the tip of the iceberg rather than more evenly across the board. Recognizing the governance gap within corporate America should lead to concrete policy changes. First, investors should make a targeted effort to establish a model of more broad-based, equitable engagement rather than their current top-heavy engagement practices. While resource constraints are unlikely to change, broad-based engagement is still possible. Many small-cap companies are low-hanging fruit: these companies are more likely to take a call from BlackRock or Vanguard and to adopt governance changes in response to requests without significant resistance. More systematically, investors could adopt specific corporate governance guidelines for small-cap corporations. These guidelines can target systemic governance failures in small companies, thus reducing the need to engage with individual companies.

Second, many companies currently measure their performance and policies against their "peer group."[289] Often, peers will be chosen based on their similarity to the company in order to better compare "apples to apples." Our findings

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286. Gregory et al., *supra* note 19.

287. *See supra* Section II.A.1.

288. Scott Hirst & Kobi Kastiel, *Corporate Governance by Index Exclusion*, 99 B.U. L. REV. 1229, 1251 (2019) (explaining that certain types of investment companies invest only in small and mid-size companies); Lizzie Chapman & Aashika Jain, *What Are Index Funds and How Do They Work?*, FORBES (Aug. 27, 2021, 3:32 PM), https://www.forbes.com/advisor/in/investing/what-are-index-funds-and-how-do-they-work [https://perma.cc/4ZPP-S96H] (explaining that market-capitalization index funds dedicate a portion of the fund to large-cap companies and a portion to small-cap companies).

289. Wayne Guay, Matthew Bloomfield & Oscar Timmermans, *Relative Performance Evaluation and the Peer Group Opportunity Set*, FINREG BLOG (July 19, 2021), https://sites.law.duke.edu/thefinregblog/2021/07/19/relative-performance-evaluation-and-the-peer-group-opportunity-set [https://perma.cc/UU8G-QDSL]; *see, e.g.*, Markku Kaustia & Ville Rantala, *Social* support the inclusion of a few "oranges"—large-cap companies—in these peer-group evaluations of small-cap companies. Including at least one large-cap company would allow investors—and the company itself—to get a sense of the company's governance structure not only compared with other small-cap companies (which may suffer from the same governance malfeasance) but also against the gold standard of large-cap companies.

Finally, investors must insist that small-cap companies disclose more information than they currently do (at times in violation of their listing duties) and that this information include key governance metrics. More disclosure would allow investors to identify lagging corporations and incentivize companies to improve their governance arrangements ex ante.

2. *Regulators*

Regulators, too, need to acknowledge the governance gap and the underlying disparity in investor attention and activism that could contribute to change. Doing so would require regulators to subject smaller companies to upgraded disclosure practices[290] and, at the same time, to reduce some of the barriers that restrict governance making in smaller companies. There are many avenues to address both approaches, but here we highlight two.

First, regulators may need to creatively promote practices that make it easier for governance debates to take place in small-cap corporations. One potential avenue is to leverage the annual meeting as a place for governance creation. By making annual meetings more accessible to shareholder participation and engagement, regulators could increase the likelihood of shareholder proposals addressing governance changes as well as the public scrutiny that management and the board could face.[291]

Learning and Corporate Peer Effects, 117 J. FIN. ECON. 653 (2015), http://web.econ.keio.ac.jp/staff/tets/kougi/tiu/2018/reading/1-s2.0-S0304405X15000999-main.pdf [https://perma.cc/X2F2-L6DB]; Hailiang Zou, Xuemei Xie, Xiaohua Meng & Mengyu Yang, *The Diffusion of Corporate Social Responsibility Through Social Network Ties: From the Perspective of Strategic Limitation*, 26 CORP. SOC. RESP. & ENV'T MGMT. 186 (2019), https://onlinelibrary.wiley.com/doi/full/10.1002/csr.1670 [https://perma.cc/6HYW-K5H3]; Yi-Wen Chen, Konan Chan & Yuanchen Chang, *Peer Effects on Corporate Cash Holdings*, 61 INT'L REV. ECON. & FIN. 213 (2019), https://www.sciencedirect.com/science/article/pii/S105905601730610X [https://perma.cc/V9MA-R72P].

290. There is a separate and interesting question as to whether this enhanced disclosure requirement should also apply to large, private companies. *See* Jennifer S. Fan, *Regulating Unicorns: Disclosure and the New Private Economy*, 57 B.C. L. REV. 583, 598-610 (2016); Pollman, *supra* note 87, at 157-59.

291. *See* Yaron Nili & Megan Shaner, *Virtual Annual Meetings: A Path Toward Shareholder Democracy and Stakeholder Engagement*, 63 B.C. L. REV. (forthcoming 2022) (discussing the role of annual meetings in promoting shareholder engagements).

A second possible solution is to ease the regulatory environment under which current activist shareholders operate, enhancing their ability to engage with small companies and initiate governance changes through the submission of proposals. A recent SEC-proposed reform of Rule 14a-8 would thwart this approach. By substantially increasing the holding thresholds for submitting and resubmitting shareholder proposals, the proposed reform would impose a significant burden on small shareholders who wish to be involved in the process of shaping corporate governance norms through the submission of shareholder proposals.[292] We believe that our analysis, which suggests that the lack of shareholder incentives is a key element in the governance problems of small firms, provides a justification for exempting small companies from such future legislation or rulemaking.[293]

3. *Academia*

The fact that corporate governance is company-dependent is not a revelation for many governance researchers. Over the past twenty years, financial economists and governance scholars have constructed governance indexes as a means to distinguish companies with shareholder-friendly governance regimes from those controlled by management.[294] Yet, too often, those differences were assumed to be the result of private ordering or intrafirm dynamics between shareholders and management. Put differently, researchers often explain each firm's idiosyncratic governance in isolation.

This Article shifts the spotlight to the systemic deficiencies in the channels of governance making in smaller companies that are independent of each firm's specific circumstances. This, in turn, invites follow-up attention, both quantitatively and qualitatively, to the systemic governance differences across market sizes and to the mechanisms of governance making, rather than the "per-firm" approach often taken in corporate governance research.

292. *See* Kastiel & Nili, *supra* note 50, at 618-19, 625.

293. Another possible solution, which was previously proposed by Bebchuk and Hamdani, is to adopt predetermined default terms that benefit shareholders at the IPO stage. This is because the "veto power of the board produces an asymmetry between arrangements favored by management and arrangements disfavored by management. Value-decreasing default arrangements that management disfavors would be presumably reversed." Lucian Ayre Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 502 (2002). The rationale behind this solution remains valid for the case of small firms due to the low likelihood of shareholders playing an active role in amending default arrangements that they disfavor.

294. *See* Bebchuk et al., *supra* note 197; Gompers et al., *supra* note 5; Spamann, *supra* note 197.

B. The Crucial Role of Proxy Advisors in Small Firms

The last few years have seen a growing debate regarding the role of proxy advisors in the market and how their activity should be regulated.[295] Supporters of proxy-advisor regulation claim that investors follow their recommendations blindly when making voting decisions and that this tendency endows proxy advisors with significant power and control over many voting decisions in the market.[296] They also claim that proxy advisors suffer from conflicts of interest and a lack of transparency.[297] Proxy advisors, on the other hand, insist that investors tend to shape their own governance policy independently.[298]

Because of this perceived influence of proxy advisors on the market, pressure has mounted to regulate their activity. For example, 2017 House Bill 4015 aimed to amend the Securities Exchange Act of 1934 and impose regulations on proxy advisors.[299] Recently, the SEC voted to adopt amendments to the Securities Exchange Act, which would introduce additional regulations over proxy voting.[300] These amendments impose further filing and information requirements upon proxy advisors and subject them to the Exchange Act Rule 14a-9, which prohibits false or misleading statements. To qualify for exemptions to reporting requirements, the proposed rule would require proxy advisory services to provide specified conflicts-of-interest disclosures in their proxy-voting advice and to allow businesses to review and give feedback on the proxy advisory drafts before sending them to clients.[301]

Our study contributes to this debate by shedding light on a particular aspect of proxy advisors' activity: namely, the crucial role they play in disciplining small

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295. *See, e.g.*, Tuch, *supra* note 213, at 1459.

296. *See* Kastiel & Nili, *supra* note 58, at 331.

297. *See, e.g.*, Timothy M. Doyle, *The Conflicted Role of Proxy Advisors*, AM. COUNCIL FOR CAP. FORMATION 7, 10-11 (May 2018), https://accfcorpgov.org/wp-content/uploads/2018/05/ACCF_The-Conflicted-Role-of-Proxy-Advisors.pdf [https://perma.cc/32W7-A32P]; Michael Cappucci, *The Proxy War Against Proxy Advisors*, 16 N.Y.U. J.L. & BUS. 579, 595-602 (2020).

298. *See* Kastiel & Nili, *supra* note 58, at 331-32.

299. Corporate Governance Reform and Transparency Act of 2017, H.R. 4015, 115th Cong. (2017).

300. Press Release, U.S. Sec. & Exchange Comm'n, SEC Adopts Rule Amendments to Provide Investors Using Proxy Voting Advice More Transparent, Accurate and Complete Information (July 22, 2020), https://www.sec.gov/news/press-release/2020-161 [https://perma.cc/7RSA-FXBE].

301. *Id.*; *see also* Nicolas Grabar, James Langston & Helena Grannis, *The SEC Takes Action on Proxy Advisory Firms*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 19, 2020), https://corpgov.law.harvard.edu/2020/08/19/the-sec-takes-action-on-proxy-advisory-firms [https://perma.cc/U8WT-EQVX] (noting that the new U.S. Securities and Exchange Commission guidelines require proxy advisory firms to disclose conflicts of interest and create procedures to ensure proxy-voting advice is made available).

companies. As Section I.B.2 showed, market participants have limited incentive to collect information about small firms, engage with them, and amend their governance structures. A key reason for this lack of incentive is that these firms typically represent only a small fraction of the portfolios of institutional investors.

In those firms, proxy advisors play a significant role in advancing the assimilation of corporate governance practices that are favorable to investors. First, they help reduce costs of engagement by pooling resources, such as research, that are necessary for the process. Additionally, they facilitate the adoption of governance practices that the majority of investors support by posing a credible threat of withholding campaigns against directors and boards that do not respond to shareholder-passed proposals. This threat has led boards to pay closer attention to strongly supported precatory shareholder proposals, giving them the potential to be quasibinding.[302]

A recent report sheds light on the potential role that proxy advisors could play in disciplining small-cap companies.[303] The report reveals that ISS recommended against votes for 369 directors outside of the S&P 500, compared with only three within the S&P 500.[304] ISS also drew attention to other issues within smaller-cap companies, including 114 withhold or against recommendations stemming from a lack of formal nominating committee, with only two recommendations coming from within the S&P 500. Of the 47 against or withhold recommendations stemming from poison-pill issues, none were within the S&P 500. While small companies are often inattentive to shareholder concerns,[305] we believe that the increased pressure from ISS could eventually lead to change.

Therefore, regulators should pay close attention to the role of proxy advisors in developing and enforcing corporate governance practices in small corporations. They should consider the necessity of further regulation of proxy advisors, as well as the appropriate shape and level of such regulation. At the same time, they must keep in mind that regulations that will push proxy advisors out of business may eliminate the potential benefits associated with their operation and effectively result in an aggravation of small firms' governance problems.

302. *See* Kastiel & Nili, *supra* note 50, at 606-07.

303. *2019 Proxy Season Review: Part 2–ISS Negative Recommendations Against Directors*, SULLIVAN & CROMWELL LLP (July 25, 2019), https://www.sullcrom.com/files/upload/SC-Publication-2019-Proxy-Season-Review-Part-2-ISS-Negative-Recommendations-Against-Directors.pdf [https://perma.cc/RUZ9-UWJR].

304. *Id.* at 2.

305. *Id.* at 7-8 (noting that no directors of S&P 500 companies were nonresponsive to low "say-on-pay" votes or other shareholder concerns, whereas "a meaningful number" of directors within Russell 3000 companies were cited as nonresponsive).

C. *Facilitating Governance Changes in Small Firms*

Finally, beyond the specific suggestions we highlight above, we believe that a more comprehensive approach is required to effectively address the governance gap between large and small firms. Even if market participants pay more attention to the governance of small firms, this does not necessarily ensure that they will exert meaningful efforts to enhance these firms' governance standards. Our analysis shows that private ordering is likely to be ineffective in small firms due to severe structural incentive problems.

Prominent scholars have long argued for the use of private ordering as the most appropriate way to tie governance structure to the specific characteristics of firms.[306] This Article casts doubt on that position. Private ordering can work well only if there are no barriers for initiating governance changes when necessary. As we show, there are severe structural incentive problems that prevent a seamless dissemination of governance practices from large to small firms. In particular, once a small firm goes public with certain governance terms, institutional investors and activist individual shareholders have limited incentive to engage with it to initiate necessary governance changes. That is, the ability to switch from a problematic default to a governance arrangement that shareholders favor is much more limited in small companies.

We suggest rethinking how governance terms are adopted in small public firms, focusing on the need to facilitate the initiation of governance changes in those firms as a means of overcoming the structural incentive problems associated with them. One possible solution is to adopt an automatic balloting mechanism that would require small companies to put certain corporate governance matters to a shareholder vote. This automatic balloting system is similar to the existing "say-on-pay" vote[307] and recent proposals on "say-on-purpose."[308] A nonbinding shareholder vote on the most common governance issues would

306. *See* sources cited *supra* note 83.

307. Say-on-pay votes offer shareholders the opportunity to cast an advisory vote on the compensation of the highest paid executives. *See, e.g.*, Off. of Inv. Educ. & Advoc, *Investor Bulletin: Say-on-Pay and Golden Parachute Votes*, U.S. SEC. & EXCHANGE COMM'N (Mar. 2011), https://www.sec.gov/investor/alerts/sayonpay.pdf [https://perma.cc/H2TX-DJBK]. For a recent analysis of shareholder voting patterns on say-on-pay votes, see Albert H. Choi, Andrew C.W. Lund & Robert Schonlau, *Golden Parachutes and the Limits of Shareholder Voting*, 73 VAND. L. REV. 223, 225-26 (2020).

308. Alex Edmans & Tom Gosling, *How to Give Shareholders a Say in Corporate Social Responsibility*, WALL ST. J. (Dec. 6, 2020, 11:00 AM ET), https://www.wsj.com/articles/how-to-give-shareholders-a-say-in-corporate-social-responsibility-11607270401 [https://perma.cc/2DL4-FH3Z]; *see also* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCT. 247, 270 (2017) (arguing that maximizing shareholder value is not always an appropriate corporate purpose).

take place each year, potentially on a rotating schedule. We recommend that this mechanism concentrate mostly on proposals that relate to market-wide corporate governance standards that could be applied to a large number of companies. The list of proposals that could be brought to an automatic shareholder vote in small companies would be based on the most popular governance terms that were adopted in S&P 500 firms in the past five years. The vote would initially indicate whether shareholders are unhappy with the corporate governance arrangement currently in place, and if so, companies would be required to bring a more detailed proposal for reform to a shareholder vote.

Such a mechanism, which is not heavy-handed and entails trivial costs for public companies, would eliminate the dependency on insufficiently incentivized shareholders for submitting proposals. It would also shift the focus of the norm-adoption process from proposal initiation to substantive debating and voting.[309]

CONCLUSION

In this Article, we report the results of a multiyear effort to shed light on a stark dichotomy in the governance of public firms. While the largest firms are making strides in adopting corporate governance arrangements that are viewed as socially and economically valuable, many smaller firms are not. This discrepancy is not random; it can be traced directly to the basic structure of our corporate governance ecosystem, which relies heavily on private actors to advance governance changes. Private ordering provides many benefits, but it is failing smaller companies, their shareholders, and society at large.

Recognizing the existence of the Corporate Governance Gap has concrete policy ramifications for investors and regulators. It also calls for a broader realignment of research and policy-making—one that considers the specific environment in which smaller public companies operate. By shedding light on this gap, our Article stresses the need to find a systemic solution for companies traditionally relegated to the sidelines of public attention. In so doing, it seeks to spark a discourse on how best to move in that direction.

309. *See* Kastiel & Nili, *supra* note 50, at 631.